

Nova Law Review

Volume 17, Issue 4

1993

Article 13

Truth in Lending - Rescission and Disclosure Issues in Closed - End Credit

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Abstract

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KEYWORDS: right, property, fees

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TABLE OF CONTENTS

I.	INTRODUCTION	1253
II.	RIGHT OF RESCISSION	1259
	A. <i>Nature of the Right</i>	1259
	B. <i>The Rescission Period</i>	1265
	C. <i>Premature Performance</i>	1270
	D. <i>Sale or Transfer of Property</i>	1276
	E. <i>Refinancing and the Right to Rescind</i>	1278
	F. <i>Obligations of the Parties</i>	1283
III.	SECURITY INTERESTS: IDENTIFICATION	1287
IV.	FINANCE CHARGE	1291
	A. <i>The Hidden Charge</i>	1291
	B. <i>Fees</i>	1298
	C. <i>Insurance Coverage</i>	1308
V.	CONSUMER OPTIONS	1313
	A. <i>Damages</i>	1313
	B. <i>Recoupment</i>	1320
	C. <i>An Attorney's Fee</i>	1323
VI.	CONCLUSION	1327

I. INTRODUCTION

The passage of the Truth in Lending Act¹ in 1968 was welcome news to consumers. For a long time, consumers had based their credit decisions on inadequate information. Rather than attempting to cure all ills in the marketplace,² Congress designed the Act to require lenders to make certain

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1. Truth in Lending Act of 1968, Pub. L. No. 90-321, 82 Stat. 146 [hereinafter TILA] (codified as amended at 15 U.S.C. §§ 1601-1667e (1988 & Supp. III 1991)).

2. *Truth in Lending—1967: Hearings on S. 5 Before the Subcomm. on Financial*

disclosures so that consumers could compare the terms of available credit. It was time to establish a uniform system of disclosure to help the average consumer make an informed decision because banks, merchants, finance companies and other creditors followed different practices in disclosing the cost of credit.³ When the Federal Reserve Board published Regulation Z⁴ to carry out the purposes of the Act, it completed the scheme for creditors' compliance with the new disclosure requirements.

The Act was not intended as a wholesale indictment of the credit industry.⁵ Nevertheless, there was so much evidence of questionable credit practices that Congress recognized the need to protect the honest businessman from unethical competition by requiring disclosures in standard terminology.⁶ Under this system, the reputable lender had nothing to fear; if anything, his disreputable counterpart would be exposed to the world at large.

The Act does not regulate loan rates. It merely deals with information about credit so that consumers can determine the reasonableness of a lender's charge.⁷ Some creditors advertised a low interest rate while adding

Institutions of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 1-2 (1967) (statement of Senator Proxmire).

3. The Report of the Senate Banking and Currency Committee put it this way: The committee believes that by requiring all creditors to disclose credit information in a uniform manner, and by requiring all additional charges incident to credit to be included in the computation of the annual percentage rate, the American consumer will be given the information he needs to compare the cost of credit and to make the best informed decision on the use of credit. S. REP. NO. 392, 90th Cong., 1st Sess. 3 (1967).
4. Regulation Z, 12 C.F.R. §§ 226.1-30 (1992). The Board of Governors of the Federal Reserve System issued Regulation Z in 1969 to carry out the purposes of the Act. TILA, Pub. L. No. 90-321, 82 Stat. 146 (1968). After Congress simplified the Act in 1980 through the Truth in Lending Simplification and Reform Act of 1980, Title VI, Pub. L. No. 96-221, 94 Stat. 168, the Board overhauled the Regulation in 1981.
5. The Senate Report on the Truth in Lending bill states that: "The bill contains no assumptions that consumer credit is bad or that the vast majority of those who extend consumer credit are engaged in deceitful practices. The bill contains no indictment of the credit industry as a whole." S. REP. NO. 392, 90th Cong., 1st Sess. 2 (1967).
6. *Id.*
7. The Senate Committee on Banking and Currency described the purpose of the legislation as follows:

The basic purpose of the truth in lending bill is to provide a full disclosure of credit charges to the American consumer. The bill does not in any way regulate the credit industry nor does it prescribe ceilings on credit charges. Instead, it requires that full disclosure of credit charges be made so that the consumer can decide for himself whether the charge is reasonable.

miscellaneous charges to produce a better yield.⁸ Other creditors merely gave a dollar figure, leaving consumers to their own devices in computing the loan rate.⁹ A consumer who did not make the necessary computations for the percentage rate had no way of comparing a transaction with other available loans. This led to the requirement that lenders must disclose the finance charge as an annual percentage rate. In this way, consumers could determine not only the actual amounts they were paying, but also the exact price of the credit.¹⁰ The consumers would, therefore, be more sensitive to rates and could make meaningful comparisons because all creditors would be bound by the same rules.

In addition, it was expected that the disclosure of an annual rate would not only restore competition among lenders but also improve the allocation

Id. at 1.

Similar language found its way into the Act. Section 1601(a) states that "[i]t is the purpose of [Truth in Lending] to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit" TILA § 102(a), 15 U.S.C. § 1601(a); *see also Truth in Lending, 1967: Hearings on S. 5 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 1 (1967) (statement of Senator Proxmire).*

8. S. REP. NO. 392, 90th Cong., 1st Sess. 3 (1967). One witness testified at the legislative hearings that there were three basic ways of stating a finance rate—the monthly system, the add-on system and the discount system. The lender could then add additional charges such as finder's fees, filing fees, credit insurance premiums, etc. *Truth in Lending, 1967: Hearings on S. 5 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 40-41 (1967) (statement of Paul H. Douglas, Chairman, National Commission on Urban Affairs).*

9. The Senate Report on Truth in Lending states that: "Although most creditors do disclose the dollar cost of credit, testimony before the committee has revealed that there are some who quote only the monthly payments. When this is done the consumer has absolutely no idea of the amount of the finance charge or the rate." S. REP. NO. 392, 90th Cong., 1st Sess. 3 (1967). The same point was made at the hearings when one witness said that "[w]hile the consumer has some knowledge of the goods and services he is buying, and in almost all cases knows the price, few consumers are really aware either of the dollar cost or of the annual percentage rate paid for the use of credit." *Truth in Lending, 1967: Hearings on S. 5 Before the Subcomm. on Financial Institutions of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 84 (1967) (statement of Joseph W. Barr, Under Secretary, U.S. Treasury Department).*

10. One legislator explained the Truth in Lending legislation this way:

This legislation will enable the consumer to know what he is paying for credit. It does not regulate credit. It just makes the firms in the credit industry let the customer know what any transaction is going to cost him in terms of dollars and cents and also in terms of the equivalent interest rate.

114 CONG. REC. 14,394-95 (1968) (remarks of Mr. Minish).

of resources within the marketplace. Consumers were expected to gravitate towards those lenders whose rates were competitive and avoid those lenders whose rates were out of line.

Nevertheless, there have been occasional misunderstandings about the elements of the finance charge. In some respects, the Regulation has caused problems by allowing lenders to exclude certain items from the finance charge by itemizing them.¹¹ These problems have arisen frequently in credit insurance.¹² It has also been difficult for courts to determine if a seller's profit includes a finance charge because consumers often have uneasy feelings about the hidden charge in a transaction. In large measure, the question is whether the charge is "an incident to or a condition of the extension of credit."¹³

If a lender does not make the required disclosures, the consumer can

11. Regulation Z allows a creditor to exclude the following charges from the finance charge if the creditor itemizes and discloses them to the customer:

(1) Taxes and fees prescribed by law that actually are or will be paid to public officials for determining the existence of or for perfecting, releasing, or satisfying a security interest.

(2) The premium for insurance in lieu of perfecting a security interest to the extent that the premium does not exceed the fees described in paragraph (e)(1) of this section that otherwise would be payable.

Regulation Z, 12 C.F.R. § 226.4(e)1-2.

12. Section 226.4(d) of Regulation Z provides in pertinent part:

Insurance. (1) Premiums for credit life, accident, health, or loss-of-income insurance may be excluded from the finance charge if the following conditions are met:

(i) The insurance coverage is not required by the creditor, and this fact is disclosed.

(ii) The premium for the initial term of insurance coverage is disclosed. If the term of insurance is less than the term of the transaction, the term of insurance also shall be disclosed

(iii) The consumer signs or initials an affirmative written request for the insurance after receiving the disclosures specified in this paragraph. Any consumer in the transaction may sign or initial the request.

Id. § 226.4(d)(1)(i)-(iii).

13. Regulation Z defines a finance charge as follows:

The finance charge is the cost of consumer credit as a dollar amount. It includes any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit. It does not include any charge of a type payable in a comparable cash transaction.

Id. § 226.4(a).

recover damages¹⁴ for the lender's violation, but the consumer must bring this action within one year after the breach.¹⁵ Nevertheless, the consumer may still recover through recoupment even if the one-year period has expired.¹⁶ Recent queries have centered on the difference between recoupment, which is defensive in nature, and affirmative action to recover for a lender's violation.

Another major feature of the Act is the right of rescission.¹⁷ Congress was concerned with abuses in the home improvement industry that resulted in a lien on a consumer's residence.¹⁸ Quite often, a consumer would contract at exorbitant rates for work on his property without realizing the seriousness of the undertaking. The consumer has three business days to cancel the transaction¹⁹ and the lender is not supposed to make any disbursements until the expiration of that period.²⁰ That is easier said than

14. A person can recover any actual damage suffered plus a penalty not less than \$100 nor more than \$1,000. TILA § 130(a)(1)-(2), 15 U.S.C. § 1640(a)(2)(A)(i).

15. *Id.* § 1640(e).

16. *Id.*

17. With certain exceptions, a consumer has the right to rescind a credit transaction if a security interest is taken in his principal dwelling. TILA § 125, 15 U.S.C. § 1635; Regulation Z § 226.23(a)(1), 12 C.F.R. 226.23(a)(1). The right of rescission does not apply to a security interest that is created to finance the acquisition or initial construction of the consumer's principal dwelling nor to a refinancing or consolidation by the same creditor of credit already secured by that dwelling. TILA § 125(e), 15 U.S.C. § 1635(e); Regulation Z, 12 C.F.R. §§ 226.2(a)(24), 226.23(f)(1)-(2).

18. One of the House managers of the legislation explained this provision as follows:

[A]nother provision of the bill is also vitally important. That is the Cahill amendment, or rather a series of amendments in the House, to strike at home improvement racketeers who trick homeowners, particularly the poor, into signing contracts at exorbitant rates, which turn out to be liens on the family residences. Any credit transaction which involves a security interest in property must be clearly explained to the consumer as involving a mortgage or lien; any such transaction involving the consumer's residence—other than in a purchase-money first mortgage for the acquisition of the home—carries a 3-day cancellation right.

114 CONG. REC. 14,388 (1968) (remarks of Rep. Sullivan).

19. TILA § 125(a), 15 U.S.C. § 1635(a); Regulation Z, 12 C.F.R. § 226.23(a)(3). The House version of the bill required a three-day waiting period before the credit contract could be signed. The conference substitute allowed the contract to be signed, but then gave the consumer three days in which to cancel. H.R. REP. NO. 1397, 90th Cong., 2d Sess. 26 (1968).

20. The Regulation requires a creditor to delay his performance by providing as follows: Unless a consumer waives the right of rescission under paragraph (e) of this section, no money shall be disbursed other than in escrow, no services shall be

done. A lender may think it necessary to accept a customer's assurance in advance that the customer will not rescind, thus diluting the ability of the consumer to make a serious review of the transaction.²¹ Although the Regulation prescribes the procedure for restoring the parties to their previous positions after the consumer has exercised his right to rescind,²² lenders have always been concerned about their insecurity once the mortgage lien is extinguished. Other difficulties arise when a lender does not act on the consumer's rescission, thus jeopardizing the lender's own chances of retrieving the property.²³ In such situations, the lender may find itself not only forfeiting that property, but also subjecting itself to liability for attorney's fees.²⁴

performed and no materials delivered until the rescission period has expired and the creditor is reasonably satisfied that the consumer has not rescinded.

Regulation Z, 12 C.F.R. § 226.23(c).

21. By taking an advance statement of non-rescission, a creditor satisfies himself that the consumer has not rescinded so that he can make a prompt disbursement at the end of the three-day period. Nevertheless, the question is whether the creditor must wait until the end of that period to entertain any statement from the consumer that the consumer has not rescinded. Even though a creditor does not disburse funds in the interim, the consumer's statement may operate to hamper a true exercise of his rescission option. If it is a true waiver situation where the consumer needs immediate funds, the creditor can use the waiver provision for the borrower to meet "a bona fide personal financial emergency." *See id.* § 226.23(e); 114 CONG. REC. 14,388 (1968) (remarks of Rep. Sullivan).

22. TILA § 125(b), 15 U.S.C. § 1635(b); Regulation Z, 12 C.F.R. § 226.23(d). Representative Sullivan explained this provision:

I want to emphasize that the rights given to the buyer or borrower under the conference substitute have real teeth. When the debtor gives notice of intention to rescind, that voids the mortgage absolutely and unconditionally, regardless of whether either the debtor or the creditor does any of the things that section requires be done subsequent to the giving of notice of intention to rescind. This would be true even where the original creditor had meanwhile negotiated the paper to some third party.

114 CONG. REC. 14,388 (1968) (remarks of Rep. Sullivan).

The Conference Report agreed that "[u]pon exercise of this right, any security interests created under the transaction are voided, the creditor must refund any advances, and the obligor must tender back any property, or its reasonable value, which he has received from the creditor." H.R. REP. NO. 1397, 90th Cong., 2d Sess. 26 (1968).

23. Unless a court orders otherwise, a consumer has an obligation to return a creditor's property only if the creditor performs his obligations under the rescission provision. TILA § 125(b), 15 U.S.C. § 1635(b); Regulation Z, 12 C.F.R. § 226.23(d).

24. If a creditor does not take possession of his property within twenty days after the consumer tenders it, then the consumer may keep it. TILA § 125(b), 15 U.S.C. § 1635(b) (1988); Regulation Z, 12 C.F.R. § 226.23(d)(3). The creditor's liability for a reasonable attorney's fee arises in the case of "any successful action to enforce . . . liability or in any

This article will discuss these issues within the context of closed-end credit.²⁵ The article will also discuss the proper treatment of a creditor's security interest.²⁶ In conclusion, the article will suggest that there is room for expansion in the area of truth in lending, and will propose ways of making the disclosures more meaningful for the average consumer.

II. RIGHT OF RESCISSION

A. *Nature of the Right*

A consumer has the right to rescind a transaction that creates a lien on his home, but he must exercise that right within three business days following consummation, delivery of the notice of the rescission right, or delivery of all material disclosures, whichever occurs last.²⁷ Congress thought it necessary to give the consumer a chance to reflect on any transaction that would involve a security interest on the consumer's principal dwelling.²⁸ Many consumers fell victim to the temptation of encumbering their homes because of some scheme that they could ill afford. It was understandable, therefore, that rescission would be limited to a lien affecting current ownership and would not apply to a purchase-money mortgage, for in the latter case the loan would be used to secure housing for the consumer,

action in which a person is determined to have a right of rescission." TILA § 130(a)(3), 15 U.S.C. § 1640(a)(3).

25. Closed-end credit means consumer credit other than open-end credit and the latter is defined as:

[c]onsumer credit extended by a creditor under a plan in which:

- (i) The creditor reasonably contemplates repeated transactions;
- (ii) The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and
- (iii) The amount of credit that may be extended to the consumer during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid.

Regulation Z, 12 C.F.R. § 226.2(a)(20).

26. In closed-end credit a creditor does not need to disclose in its general disclosure statement a security interest that arises solely by operation of law. *Id.* § 226.2(a)(25). However, the right of rescission does apply to such security interests and the creditor has to give the consumer a notice of that right. *Id.*

27. TILA § 125(a), 15 U.S.C. § 1635(a); Regulation Z, 12 C.F.R. § 226.23(a)(3).

28. S. REP. NO. 368, 96th Cong., 1st Sess. 28 (1978), reprinted in 1980 U.S.C.C.A.N. 236.

rather than to make shabby repairs or worthless investments.²⁹

A consumer cannot rescind a transaction simply because there is a mortgage lien on his property. The lien must be on the consumer's principal dwelling³⁰ and the loan must be primarily for personal, rather than commercial uses.³¹ Therefore, if most of the proceeds are used in some business venture, the loan would not be rescindable. This does not mean, however, that the consumer must use all the money for one purpose or the other. The emphasis is on the primary application of the funds, and the consumer may well commit some funds to one purpose, while using the major part of the loan for another purpose.³² In assessing the purpose of the loan, the lender should rely generally on the consumer's loan application. Therefore, if the consumer actually commits the money to personal use after telling the lender that he needs it for his business, the lender should be excused for not making disclosures.³³ Otherwise, the lender would be required to supervise the borrower's business to ensure that the borrower used the money for the stated purpose.

An interesting question arises as to whether a consumer should have the right to rescind a loan secured by his home if he uses the proceeds to pay off another lender who was going to foreclose on a previous loan. In *Stillman v. First National Bank*,³⁴ the consumer advised the lender that he wanted the loan for business; the consumer subsequently tried to rescind.

29. Rescission does not apply to a residential mortgage transaction. TILA § 125(e), 15 U.S.C. § 1635(e); Regulation Z, 12 C.F.R. § 226.23(f)(1). A residential mortgage transaction is one in which a mortgage is given to finance the acquisition or initial construction of a consumer's principal dwelling. Regulation Z, 12 C.F.R. § 226.2(a)(24).

30. Regulation Z, 12 C.F.R. § 226.23(a)(1). The term "dwelling" is defined as "a residential structure that contains 1 to 4 units, whether or not that structure is attached to real property." *Id.* § 226.2(a)(19). The Official Staff Interpretations (Commentary) explains that under this definition mobile homes, boats and trailers are regarded as dwellings if they are in fact used as residences. Official Staff Interpretations § 226.2(a)(19)-2 [hereinafter Commentary]. The Commentary represents the interpretations of Regulation Z by the Federal Reserve Board staff and each comment in the Interpretations is identified by a number and its corresponding Regulation Z section. *Id.* at Introduction-1.

31. Regulation Z applies only to consumer credit which is defined as "credit offered or extended to a consumer primarily for personal, family, or household purposes." *Id.* § 226.2(a)(12).

32. *Heuer v. Forest Hill State Bank*, 728 F. Supp. 1199, 1200 (D. Md. 1989), *aff'd*, 894 F.2d 402 (1990).

33. *CIT Fin. Serv., Inc. v. Bowler*, 537 So. 2d 4 (Ala. 1988) (loan not subject to Truth in Lending when borrower used part of the loan for personal debts but most of it to start a medical practice).

34. 791 P.2d 23 (Idaho Ct. App. 1990).

The consumer justified his right to rescind on the ground that he had secured the loan to save his home from foreclosure by the Small Business Administration, the previous lender, and that the new loan was therefore personal in nature.³⁵

In *Stillman*, the lender's only indicator regarding the purpose of the loan was the debtor's statement in the loan application that the loan was for business. The lender did not have any information about the debtor's pressure to save his home from foreclosure; thus, the court was guided by the debtor's statement of purpose.³⁶ It is questionable whether the lender should have done anything different if it had known about the debtor's motivation to save his home from foreclosure. In a similar situation, one court distinguished the purpose of the loan from the motivation of the debtor and held that a loan that is used to pay off a business debt is really for a business purpose.³⁷ In *Stillman*, the original business loan was exempt from Truth in Lending even though the debtor's home was subject to forfeiture in the event of default.³⁸ There would be little basis, therefore, for granting rescission in such a case, although the enforcement of the lien would have grave consequences for the borrower and his family. Courts should look to see how the funds are to be used and not at the result of a default in the borrower's obligations.

If a consumer grants a security interest in his current principal dwelling, he has a right to rescind the transaction even if he intends to use the loan to buy a new home.³⁹ Sometimes a borrower will obtain short-term

35. *Id.* at 25.

36. *Id.* at 26. However, the court rejected the consumer's explanation and held that the loan was primarily for a commercial purpose. *Id.*

37. *Toy Nat'l Bank v. McGarr*, 286 N.W.2d 376 (Iowa 1979). A refinancing consolidated a business loan of \$12,035.26 with a personal loan of \$1,016.83. The court held that the mere fact that the refinancing staved off foreclosure on the borrowers' residence did not make the loan a consumer loan. *Id.* at 378. However, in *Anderson v. Lester*, 382 So. 2d 1019 (La. Ct. App. 1980), *cert. denied*, 450 U.S. 1045 (1981), the court placed great emphasis on the borrowers' purpose in getting the loan, to prevent seizure of their home, even though some of the money was used to pay off business debts.

38. The Commentary provides some guidance on this point:

Credit extensions that are not subject to the regulation are not covered by § 226.23 even if a customer's principal dwelling is the collateral securing the credit. For example, the right of rescission does not apply to a business purpose loan, even though the loan is secured by the customer's principal dwelling.

Commentary § 226.23-1; see also *The Exemption of Credit Primarily for Business*, CONSUMER CREDIT & TRUTH-IN-LENDING COMPLIANCE REP., Sept. 1990, at 6.

39. The Commentary provides that "[w]hen the consumer is acquiring or constructing a new principal dwelling, any loan secured by the equity in the consumer's current principal

financing to close his new home transaction before selling his current home and will offer both homes as security. In *Summit Trust Co. v. Chichester*,⁴⁰ a consumer took out a bridge loan to close the purchase of his new home. The lender took the position that the bridge loan was exempt from rescission because the borrower had used the loan to finance the new purchase. However, the court viewed the loan on the new home as rescindable because it was only a temporary arrangement which was not intended to finance the acquisition within "the spirit and intent" of the Act.⁴¹ The court held that such bridge financing did not come within the definition of a "residential mortgage transaction" because the latter type was intended for long-term, permanent financing.⁴²

The court was grateful for the guidance of the Official Staff Commentary which held that any loan secured by the equity in the consumer's current principal dwelling is rescindable even if the consumer is buying a new principal dwelling.⁴³ Although the Commentary mentions a bridge loan as an example of the application of the rule, it must be noted that the example given there relates to equity in the consumer's current dwelling; in that case, the transaction would hardly escape rescission because the mortgage would not be on the new dwelling.⁴⁴ Therefore, although the *Summit Trust* court looked to the Commentary for help, the Commentary did not really address the relevance of the new mortgage in the scheme of things. Therefore, the court must have felt that its differentiation between short-term and long-term financing was the salient element in its decision on rescission. However, nowhere does the Act or the Regulation provide a rationale for the court's distinction. In all fairness, the court should have asked the question whether the consumer could have closed the transaction without the bridge loan. If not, then the issue still remains whether the loan

dwelling (for example, a bridge loan) is still subject to the right of rescission regardless of the purpose of that loan." Commentary § 226.23(a)(1)-4.

40. 559 A.2d 12 (1989).

41. *Id.* at 16.

42. *Id.* The Regulation defines a residential mortgage transaction as one in which "a mortgage . . . or equivalent consensual security interest is created or retained in the consumer's principal dwelling to finance the acquisition or initial construction of that dwelling." Regulation Z, 12 C.F.R. § 226.2(a)(24).

43. See *supra* note 39.

44. The Commentary makes the point that a consumer can have only one principal dwelling at any one time. It goes further and suggests that "[w]hen a consumer buys or builds a new dwelling that will become the consumer's principal dwelling within one year or upon completion of construction, the new dwelling is considered the principal dwelling when it secures the acquisition or construction loan." Commentary § 226.23(a)(1)-3.

was used to finance the purchase of the new dwelling.

It is questionable whether the loan period should be the determining factor in resolving the rescission issue, for it leaves the borrower in a quandary about the cut-off point between a rescindable and a non-rescindable transaction. One wonders whether the court would have characterized a one-year loan as a bridge loan, and therefore rescindable, even if it was definitely used to purchase the property. The Commentary provides no help on that issue because in the one-year example, the lien would be on the new property rather than the old. There is no hint in the legislation that the term or amortization of the loan should decide the question whether the loan is purchase-money.

In *Summit Trust*, there was a previous commitment from another lender for the usual purchase-money mortgage on the new house. This raises the question whether the availability of a previous loan foreclosed the possibility of having a second loan with the same objective of closing the transaction.⁴⁵ Even if the borrowers promised to repay the second loan when the old house was sold, this transaction would not be any different from one where the borrowers voluntarily prepaid the second mortgage because they found they could afford to do so subsequent to the closing.

If the bridge loan was not used to finance the purchase of the new house, why did the borrowers not proceed to closing without it?⁴⁶ The argument against treating the bridge loan this way is sustainable only if the position is taken that the proceeds from the old house would not have been used towards the new purchase, a theory without foundation, since the borrowers replaced the unavailable proceeds with the bridge loan in the new transaction. If the consumer needs a loan to consummate the purchase of his principal dwelling, then the repayment of the loan (short-term as it may be) should not detract from the underlying purpose of the transaction.

It was conceded in *Summit Trust* that the borrower could not close without the loan. He needed it to complete the transaction on his new

45. For example, if one creditor provides construction financing and another creditor permanent financing for the consumer's principal dwelling, both transactions are treated as residential mortgage transactions and therefore non-rescindable. *Id.* § 226.2(a)(24)-4. Therefore, it is possible to have different extensions of credit to finance the initial construction or purchase of the consumer's principal dwelling.

46. One of the main points in *Summit Trust* was that the financing requirement could not be met because of the temporary nature of the loan. The court took a firm position that the rescission exemption does not cover "temporary bridge loan financing" even with respect to a mortgage on the new house. 559 A.2d at 16. This is even more curious when the court conceded that the consumer's old house would no longer be the principal dwelling. *See id.*

home. There is no rationale for extending the limited right of rescission simply because the borrower has an outstanding commitment for another loan on the new property. It is not the commitment that counts but rather the circumstances under which the loan is granted. Therefore, one lender's prior commitment may be overtaken by another lender's disbursement of funds. The Commentary is not exactly clear on the special rule covering a consumer's principal dwelling. Nevertheless, it can be argued that the rule relates only to the situation where the consumer grants a lien on his current principal dwelling in the transition period without involving the future principal dwelling.⁴⁷ If the consumer needs some funds to tide him over while he tries to sell his old property, then he may give a lien on his current principal dwelling to secure those funds. Maybe he needs money for his down-payment on the new property and he is prepared to encumber his current home to realize his goal. Therefore, the Commentary rightly suggests in that case that the right of rescission applies regardless of the purpose of that loan. Such broad language would therefore include the case where the consumer's purpose in subjecting his home to a lien is to secure funds for consummating the transaction on his new home sometime later.⁴⁸ However, if the same loan covers both properties, there should be a different result. The right of rescission cannot apply to both properties because the consumer can only have one principal dwelling at a time and the consumer's simultaneous grant of a lien on both properties would mean that the consumer had opted for one of those properties as the principal dwelling.⁴⁹

47. The rule makes no reference at all to a lien on the new dwelling. It can be read, therefore, as relating to the purpose of the loan rather than to the attachment of a lien to the new principal dwelling. It may be that the consumer does not intend to give a lien on that new dwelling or that the bridge loan on the current dwelling is treated as a separate transaction because the consumer is not yet ready to acquire the new house. The special rule would clearly cover those transactions. See Commentary § 226.23(a)(1)-4.

48. The Commentary recognizes that a combined-purpose transaction may be exempt from rescission if the loan is treated as one transaction. The pertinent section reads as follows:

Combined-purpose transaction. A loan to acquire a principal dwelling and make improvements to that dwelling is exempt if treated as one transaction. If, on the other hand, the loan for the acquisition of the principal dwelling and the subsequent advances for improvements are treated as more than one transaction, then only the transaction that finances the acquisition of that dwelling is exempt.

Id. § 226.23(f)-3. Therefore, if the loan on the current principal dwelling is treated as a separate transaction, it should be regarded by analogy as rescindable without doing damage to the exemption principles.

49. The court in *Summit Trust* that the loan "was also secured by a mortgage on the old house which would no longer be the [consumer's] dwelling or principal dwelling." 559 A.2d

If one takes the view that in the two-lien transaction, the loan is not given to finance the new property and that the new property transaction is therefore rescindable, one is forced to ask a question about the loan on the old property. There would be a temptation to treat that part of the transaction as rescindable also because it seems to fit even more comfortably within the Commentary's special rule. But the rule does not take account of the existence of two liens in the same transaction, but rather suggests that where there is a lien on the consumer's current principal dwelling, the objective of securing a new home does not prevent the rescission rule from operating. The consumer's rescission would therefore affect that principal dwelling only and consequently there would be an automatic voiding of the security interest in connection therewith.⁵⁰ On the other hand, if two loans are involved, the other property would still have a lien on it and the consumer would have to take action to remove the lien because the statutory mechanism would not apply. The statute could hardly have contemplated this. Furthermore, if one argues for the proposition that both security interests are void in this scenario, then one must find that there are two principal dwellings; this seems an unlikely prospect even under the Commentary's formulation.

B. *The Rescission Period*

Under ordinary circumstances, a consumer has three days to rescind following consummation of the transaction, delivery of all material disclosures and delivery of the notice of the right to rescind, whichever comes last.⁵¹ If the lender fails to meet his disclosure obligations, the consumer's rescission right can continue for as long as three years.⁵² Quite often, a consumer will look for some basis to extend the rescission period, and he may find it by determining the consummation date of the transaction.

The Regulation describes "consummation" as "the time that a consumer becomes contractually obligated on a credit transaction."⁵³ It is clear that

at 16; see also Commentary § 226.2(a)(24)-3.

50. When the consumer rescinds, the security interest affecting his property becomes void. TILA § 125(b), 15 U.S.C. § 1635(b); Regulation Z, 12 C.F.R. § 226.23(d)(1).

51. Regulation Z, 12 C.F.R. § 226.23(a)(3).

52. The right of rescission expires "three years after consummation, upon transfer of all of the consumer's interest in the property, or upon sale of the property, whichever occurs first." *Id.*

53. Regulation Z, 12 C.F.R. § 226.2(a)(13). State law determines when a contractual obligation is created. Commentary § 226.2(a)(13)-1.

if state law allows a contract to be formed by the consumer's acceptance of a lender's commitment, consummation will occur at that time. If not, consummation will not usually occur until closing.⁵⁴ Sometimes the determination of when consummation occurs is not that clear-cut. In *Jackson v. Grant*,⁵⁵ the loan documents designated the plaintiff as the borrower and Union Home Loans as the broker or arranger of credit. The loan documents and the disclosure statement clearly stated that Union Home Loans was not the lender and that there was no guaranty to the plaintiff that she would get a loan.⁵⁶ Union Home Loans could not find a lender and finally decided on April 28, 1983, that it would make the loan. Union assigned the loan to the defendants and the plaintiff rescinded the transaction on the ground that she did not receive notice of her rescission right within three business days after consummation, which in her view occurred in April, 1983.⁵⁷

The court agreed with the plaintiff that consummation took place in April rather than February because when the parties signed the February documents there was no identifiable lender, and therefore, no commitment.⁵⁸ The consummation took place only when Union agreed to make the loan itself. Unfortunately, the lender did not give the plaintiff any notice of her rescission right at that time, and therefore, the plaintiff's right continued for three years beyond that date. Thus, the rescission was applicable against the lender's assignees even though the consumer had already received the benefit of the loan.⁵⁹

The court in *Jackson* was not particularly enthusiastic about the result but followed the lead of *Semar v. Platte Valley Federal Savings and Loan Ass'n*⁶⁰ in not granting relief only to "sympathetic consumers." It was clear to the court that Congress intended to apply Truth in Lending to all consumers and the court did not find any justification for varying the rule on the ground that some consumers merited more sympathy than others.⁶¹

54. See *Murphy v. Empire of Am.*, 746 F.2d 931 (2d Cir. 1984); *Waters v. Weyerhaeuser Mortgage Co.*, 582 F.2d 503 (9th Cir. 1978); *Baxter v. Sparks Oldsmobile, Inc.*, 579 F.2d 863 (4th Cir. 1978) (approval of appropriate lender was condition precedent to consummation).

55. 890 F.2d 118 (9th Cir. 1989).

56. *Id.* at 119.

57. *Id.*

58. *Id.* at 121.

59. *Id.* at 122.

60. 791 F.2d 699 (9th Cir. 1986).

61. *Jackson v. Grant*, 890 F.2d 118, 122 (9th Cir. 1988).

This is understandable because the Act already provides for some equitable considerations in the bona fide error defense and a defaulting creditor may avoid liability on that ground.⁶² In any event, Congress must have known that some borrowers would wait until the last minute to rescind. A lender is not entitled to much sympathy himself if a borrower's right of rescission continues beyond the three-day period simply because the lender did not comply with his statutory mandate. Therefore, there is no sound reason for criticizing a consumer who exercises his right long after consummation but nevertheless within the three-year period, because the creditor has it within his control to put the matter to rest through full compliance.

It is conceivable that consummation will not occur even though the parties have signed the loan documents. For example, in *Thomas v. Leja*,⁶³ state law required disbursement of the proceeds for consummation to occur. The lender assigned the note and mortgage to a third party even though the lender had not given any money to the consumer. The consumer was quite surprised to find out that the assignee had filed a foreclosure action to recover on the loan. Nevertheless, the consumer rescinded in good time because the parties had never consummated the transaction and the assignee saw his foreclosure efforts frustrated by this peculiarity in the state law.⁶⁴

There is a continuing right to rescind when a creditor does not make the right disclosures in a rescindable transaction. If the creditor makes the necessary corrections, the consumer should receive a new rescission notice at that time.⁶⁵ If not, the consumer would be unable to reconsider his position on the basis of the new disclosures. However, not every failure to disclose has an impact on the consumer's right of rescission. The rescission period is extended only if the creditor fails to make all *material* disclosures and does not give the necessary rescission notice.⁶⁶

62. The bona fide error defense allows a creditor to avoid liability if it can show by "a preponderance of evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid any such error." TILA § 130(c), 15 U.S.C. § 1640(c).

63. 468 N.W.2d 58 (Mich. 1991).

64. It must be recalled that state law determines when consummation occurs. See Commentary § 226.2(a)(13)-1.

65. See *Semar v. Platte Valley Fed. Sav. & Loan Ass'n*, 791 F.2d 699, 702 (6th Cir. 1986). See generally *Williamson v. Lafferty*, 698 F.2d 767 (5th Cir. 1983); *Smith v. Wells Fargo Credit Corp.*, 713 F. Supp. 354 (D. Ariz. 1989).

66. Regulation Z, 12 C.F.R. § 226.23(a)(3). The material disclosures referred to are the annual percentage rate, the finance charge, the amount financed, the total of payments, and the payment schedule. *Id.* at n.48.

In point of fact, the creditor must give the borrower two copies of the right-to-rescind notice.⁶⁷ The rationale is that the borrower can use one copy to notify the creditor that he is rescinding, while retaining the other copy to keep himself abreast of his rights. Since the borrower can use any written statement to notify the lender that he is rescinding, one would think that the lender's failure to provide two copies of the notice would not be serious enough to extend the rescission period. There would be a more compelling case for an extension of the period if by giving only one copy of the notice, the lender deprives the consumer of the opportunity to submit a mandatory official form.

It is bad enough for the lender to experience a consumer's late rescission but it is even worse when the lender has assigned the note and mortgage to another party. The assignee runs the risk of feeling the effects of the lender's inefficiency long after the expiration of the normal three-day rescission period.⁶⁸ The usual rescission procedure can be tricky but it can be a nightmare if the consumer signs the loan documents without receiving any proceeds from the lender-assignor, and the latter then assigns the documents to the assignee, after receiving payment for the assignment. When the consumer rescinds, he has nothing to return to the assignee if he never received the loan proceeds from the lender. The assignee is therefore left holding the bag, as it were, even though he may be a true holder in due course.⁶⁹ Truth in Lending, which preempts state law in this regard, makes rescission available against any assignee.⁷⁰ An assignee will therefore bear the loss if he cannot recover from the lender-assignor. After all the consumer has nothing to tender on rescission because he received nothing from the lender in the first place.

This is an unfortunate state of affairs. In a situation like this where there are two apparently innocent parties, one should look to determine who was in the better position to prevent the loss.⁷¹ It is arguable that the consumer set the transaction in motion by signing the documents without

67. The creditor must give two copies of the notice to each consumer entitled to rescind. Regulation Z, 12 C.F.R. § 226.23(b).

68. A consumer who has the right to rescind a transaction may rescind as against any assignee. TILA § 131(c), 15 U.S.C. § 1641(c).

69. *Stone v. Mehlberg*, 728 F. Supp. 1341 (W.D. Mich. 1989); *Elsner v. Albrecht*, 460 N.W.2d 232 (Mich. Ct. App. 1990).

70. *Stone*, 728 F. Supp. at 1348; *Thomas v. Leja*, 468 N.W.2d 58, 61 (Mich. Ct. App. 1991).

71. See *Consumer Borrowers v. Consumer Assignees: Part 2*, CONSUMER CREDIT & TRUTH-IN-LENDING COMPLIANCE REP., Feb. 1991, at 3.

receiving any funds. Surely then if negligence can be attributed to anyone, it must be to the consumer. The assignee would not expect to have the consumer rescinding the transaction without a corresponding tender of the proceeds. In the final analysis, the assignee cannot rely on the mere assignment to protect his interest regardless of his good faith and he should confirm the nature of the transaction with the consumer before consummating the assignment. It would be more palatable for the assignee if he could enjoy similar protection to that which is available when the consumer seeks damages for a disclosure violation. Unless the violation is apparent from the face of the instrument, damages for such a violation do not lie against the assignee.⁷² Unless there is something that puts the assignee on notice, it may be desirable to prevent the consumer from rescinding in this context. Perhaps this change would make the consumer more cautious in his dealings with the lender, who might be expected to assign the obligation to a third party.

It is the deficiency of the creditor's rescission notice that causes problems. The notice should disclose the date when the rescission expires.⁷³ It is not enough for the notice to give the date of the transaction and then to state that the rescission period expires three days from that date. The creditor must specify the actual date when the right of rescission ends.⁷⁴ The consumer should not be forced to compute the rescission period for himself. In any event, the period does not always expire on the third business day because the time to rescind does not begin to run until the transaction has been consummated and the consumer has received the proper notice and disclosures. Therefore, if the creditor gives the consumer a defective disclosure statement, the expiration date of the rescission right would not be known until the creditor provided a corrected disclosure statement. The original date in the notice would be inaccurate as a result.

The creditor may solve the problem by providing additional information in the notice of the right to rescind. The notice should not only specify the date of the third business day after consummation of the transaction but it should also indicate that the rescission period will be extended if there is a problem with the notice or the disclosure statement. Therefore, the last of those three events would dictate the expiration of the rescission period. The

72. TILA § 131(a), 15 U.S.C. § 1641(a).

73. Regulation Z, 12 C.F.R. § 226.23(b)(5).

74. *Semar v. Platte Valley & Loan Ass'n*, 791 F.2d 699 (9th Cir. 1986); *Reynolds v. D & N Bank*, 792 F. Supp. 1035 (E.D. Mich. 1992); *Mayfield v. Vanguard Sav. & Loan Ass'n*, 710 F. Supp. 143 (E.D. Pa. 1989).

period would therefore end on the third business day after the transaction, the date of receipt of the disclosure, or the date of receipt of the notice of the right to cancel, whichever occurs last.⁷⁵

The lender must be sure that it does not contradict, either orally or in writing, any notice that it gives the borrower about the right to cancel the transaction. In *Jenkins v. Landmark Mortgage Corp.*,⁷⁶ an attorney caused some difficulty for his lender-client by making contradictory statements at the closing and in his covering letter that confused matters and made the notice unclear. Therefore, the three-day rescission period never started to run because the lender did not give a clear and conspicuous notice to the borrower, thus providing the latter with a continuing right to rescind.⁷⁷ Furthermore, even though the borrower had signed a statement acknowledging receipt of a disclosure statement, that did not prevent her from repudiating the statement and showing that she did not receive the disclosures on the alleged date.⁷⁸

C. Premature Performance

In the absence of a proper waiver by the consumer, a lender should neither disburse any funds nor perform any services until the three-day rescission period has expired and the lender is reasonably satisfied that the consumer has not rescinded.⁷⁹ If the parties have taken no action, the consumer's withdrawal from the transaction should be a mere formality. Difficulties arise, however, when the lender throws caution to the wind with the expectation that the transaction will be completed quickly once the three-day period has expired. For example, in *Morris v. Lomas & Nettleton Co.*,⁸⁰ the consumers signed the usual documents at closing and also a form that they did not wish to exercise their right of rescission following the three-day period. The lender kept all the documents and waited until the end of the period to disburse the funds.⁸¹ The consumers elected to rescind sometime later but the lender would not allow them to do so. The consumers argued that the lender had induced them to waive their right of rescission

75. See 12 C.F.R. pt. 226, app. H-8 (1992).

76. 696 F. Supp. 1089 (W.D. Va. 1988).

77. *Id.* at 1095.

78. *Id.* at 1093.

79. Regulation Z, 12 C.F.R. § 226.23(c).

80. 708 F. Supp. 1198, 1202-03 (D. Kan. 1989).

81. *Id.* at 1203.

by having them sign the form at closing that indicated that they did not intend to rescind the transaction.⁸²

The court found no violation of Truth in Lending, and therefore, the consumers had no continuing right to rescind.⁸³ It is true that the lender did not violate the statute because the lender had performed no prohibited act during the three-day rescission period.⁸⁴ No waiver occurred because the lender did not advance any funds to the consumers for a financial emergency.⁸⁵ However, it would seem that permitting the lender to take the consumers' pre-signed form did affect the consumers' option of using the three-day period to mull over the transaction. The language of the *Morris* form provided some doubt about the consumers' intention. The consumers' sworn statement read as follows: "We have not exercised, and do not exercise, the right to rescind the credit transaction to which this Rescission Notice applies."⁸⁶ Since the form bore the same date as the other closing documents, it was accurate for the consumers to say that they had not exercised, and that they were not exercising, the right to rescind at the time they signed the documents. But that was not the important event, for that time came three days later. It seems, therefore, that if the rationale for accepting a form of this type was to disburse the funds quickly at the end of the three-day period, the consumers' statement of their past and present frame of mind did not provide any indication as to the consumers' future intent at the expiration of the period. The creditor still should have waited for a reasonable time thereafter to reassure itself that the consumers had not rescinded by obtaining a confirmation from them.⁸⁷

As a matter of policy, therefore, this pre-clearance form does not add anything to the process, but may confuse matters if consumers are lulled

82. *Id.* at 1204-06.

83. *Id.* at 1206.

84. A creditor cannot disburse any funds nor perform any services during the three-day waiting period, unless the parties have followed the procedure for the consumer's waiver. Regulation Z, 12 C.F.R. § 226.23(c).

85. The consumer can waive his right of rescission if he determines that he needs credit for a bona fide financial emergency. The consumer must give the creditor a signed, written statement to that effect and he cannot use a printed form. *Id.* § 226.23(e).

86. *Morris*, 708 F. Supp. at 1203.

87. The Regulation requires the creditor to delay its performance "until the rescission period has expired and the creditor is reasonably satisfied that the consumer has not rescinded." Regulation Z, 12 C.F.R. § 226.23(c). One of the ways in which a creditor may satisfy itself that the consumer has not rescinded is by getting a written statement from the consumer. But that statement should only come at the end of the rescission period. See Commentary § 226.23(c)-4.

into believing that they have already committed not to rescind and that the lender has a perfect right to take the consumers' written word as the final statement on the matter. It is difficult to give vitality to the consumer's statement that he is not rescinding when the period set aside for his review of the transaction has not yet expired.

If the above scenario appears problematic, there should be a similar reaction to a post-dated statement that the consumer has not rescinded the transaction. When the statement refers only to the time of closing, it does not pretend to address the end of the three-day period. But the present confirmation of future non-rescission obliterates the consumer's statutory right in one fell swoop. Therefore, when the court in *Curry v. Fidelity Consumer Discount Co.*⁸⁸ was confronted with a consumer's post-dated certificate that the consumer had not rescinded the transaction and also a post-dated check for the loan proceeds, it took the position that the lender had violated the statute by failing to provide the consumer with "clear notice . . . of her rescission rights."⁸⁹ There was some inconsistency in giving the consumer with one hand a notice of the three-day rescission period and then with the other hand taking a post-dated form indicating that the consumer was not rescinding. The Regulation requires the lender to disclose clearly and conspicuously the consumer's right to rescind and to provide a form for that purpose.⁹⁰ The court saw the post-dated documents as a problem because they sent mixed signals to the consumer. There seemed to be an implied understanding that the consumer would not rescind despite the three-day opportunity for reflection.

Although the *Curry* court lumped the post-dated check with the post-dated form, it is arguable that the form was more relevant to the consumer's rescission right because it contradicted the fact that the consumer had a three-day period to mull over the transaction. The post-dated check went more or less to the issue of premature performance rather than to the right of rescission.⁹¹ This point was made by the court in *Smith v. Fidelity Consumer Discount Co.*⁹² when the consumer endorsed a post-dated check

88. 656 F. Supp. 1129 (E.D. Pa. 1987).

89. *Id.* at 1132.

90. Regulation Z, 12 C.F.R. § 226.23(b). Among other things, the notice of the right to rescind must tell the consumer "[h]ow to exercise the right to rescind, with a form for that purpose, designating the address of the creditor's place of business." *Id.* § 226.23(b)(3).

91. The Commentary suggests that the creditor should not disburse loan proceeds to the consumer until the rescission period has expired and this includes not distributing the funds to the consumer as trustee or escrow agent. Commentary § 226.23(c).

92. 898 F.2d 896, 903-04 (3d Cir. 1990).

and gave it back to the lender pending expiration of the rescission period. The court viewed the endorsement as a violation of the provision prohibiting premature performance but not as a violation of the rescission provision.⁹³ The difference was significant because it meant that the lender's conduct in *Smith* did not result in an extension of the rescission period. The consumer had received all the disclosures to which he was entitled,⁹⁴ and his reliance on the lender's haste in preparing for a fast disbursement via the endorsed check after the expiration of the rescission period did not give him what he had hoped for—an opportunity to rescind at a later date.

It is possible, however, to distinguish *Smith* and *Curry*. In *Curry*, the consumer did sign a post-dated statement of non-rescission which was lacking in *Smith*. The court in *Curry* made no attempt to distinguish between the post-dated check and the post-dated statement, but one can only surmise what the court would have done if there had been no such statement. It might have seen the check as more akin to premature performance. On the other hand, the *Smith* court did not have to deal with a contradictory statement that went to the very heart of the rescission right, and therefore, it was able to isolate the single matter of the check endorsement.⁹⁵

Additionally, the court in *Smith* ruled on the issue of whether the lender's premature performance constituted a failure to deliver material disclosures.⁹⁶ It seemed to be a rather perplexing question in this context because the right of rescission had little to do with the material disclosures required of the creditor and the court rightly held that the lender had not run afoul of the provision requiring such disclosures.⁹⁷ In finding for the lender on this point, the court acknowledged that it was disagreeing with the

93. The court said "that "[t]he premature performance in this case, while a violation of § 226.23(c), is most certainly not a violation of § 226.23(b)." *Id.* at 904.

94. The consumer is entitled to receive a notice of the right to rescind and also all material disclosures. Therefore, the consumer's rescission right will be extended only if the consumer is not given the required notice or material disclosures. Regulation Z, 12 C.F.R. §226.23(a)(3).

95. Although the lender in *Curry* disbursed the proceeds to a third party on the same day as the closing, this was an act of premature performance that could hardly be distinguished from that in *Smith* where the lender took back the endorsed check from the consumer. In both cases, the creditors failed to delay their performance as required. See Commentary § 226.23(c)1-3.

96. See *Smith*, 898 F.2d at 904-05.

97. *Id.* at 904. "The term 'material disclosures' means the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments, and the payment schedule." Regulation Z, 12 C.F.R. § 226.23(a)(3) n.48 (1991).

decisions of *In re Celona*⁹⁸ and *In re Gurst*.⁹⁹ However, the *Smith* court stated that those courts had dealt with a specific violation of section 226.23(c) which required a delay in the creditor's performance rather than with a violation of the material disclosure provision.¹⁰⁰ The court in *Celona* made this point when it had no hesitation in finding "a clear violation of 12 C.F.R. § 226.23(c) on [the] record."¹⁰¹ Subsequently, the *Celona* court added that the violation was sufficiently *material* to give the debtors the right to rescind because the lender had attempted to reduce the three-day period.¹⁰² This suggested that the court viewed the lender's conduct as such an egregious violation of the debtor's right of rescission that the rescission period should be regarded as continuing. In explaining its disagreement with the *Celona* court on that score, the *Smith* court thought that the *Celona* court had argued for an expansion of the definition of "material disclosures," just because the latter had deemed the lender's violation material.¹⁰³ Both courts believed that it was the premature performance provision that the lender had violated, although the *Celona* court believed that this violation was sufficiently material that the lender should have a right to rescind the transaction.¹⁰⁴

The Regulation makes it clear that the lender should not disburse money other than in escrow, perform any services, or deliver any materials to the consumer until the rescission period has expired.¹⁰⁵ Nevertheless, the Commentary to Regulation Z explains that the creditor may take certain action during the period of delay, short of actual performance.¹⁰⁶ For example, the creditor may charge interest from the time the transaction is consummated, unless prohibited from doing so, such as by state law.¹⁰⁷ If the creditor does charge interest contrary to state law, the question arises whether that constitutes a violation of Regulation Z.

98. 90 B.R. 104 (1988), *aff'd*, 98 B.R. 705 (Bankr. E.D. Pa. 1989).

99. 79 B.R. 969 (Bankr. E.D. Pa. 1987).

100. *Smith*, 898 F.2d at 904.

101. *Celona*, 90 B.R. at 110.

102. *Id.*

103. The Truth in Lending Simplification and Reform Act introduced the definition of the term "material disclosures." Pub. L. No. 96-221, § 612(a)(2), 94 Stat. 175 (1980).

104. This illustrated a difference between a material disclosure and a material or important violation. As emphasized by the *Celona* court, a creditor can provide all the material disclosures required by the Regulation, and technically, still be guilty of a material violation.

105. Regulation Z, 12 C.F.R. § 226.23(c).

106. Commentary § 226.23(c)-3.

107. *Id.*

In *Shelton v. Mutual Savings & Loan Ass'n*,¹⁰⁸ the court held that even if the creditor's accrual of interest violated state law or the Commentary, it would not necessarily violate the Act.¹⁰⁹ Accordingly, the court did not allow the consumer to recover damages.¹¹⁰ However, the court reached the right conclusion while seeming to misinterpret the value of the Commentary. Since the Commentary is supposed to explain the meaning of the Regulation, if the court believed that the creditor had violated the Commentary, logically it should also have found a violation of the Regulation by the creditor. It was not a question whether the Act provided damages for a violation of the Commentary, but whether the creditor had violated the Regulation. The Commentary would have been helpful in making that decision.

The Commentary can be interpreted as simply drawing the creditor's attention to the fact that state law may forbid the collection of interest during the rescission period. However, collection of interest during this period, while possibly a violation of state law, is not necessarily a violation of the Regulation. The point is that the creditor may not disburse loan proceeds until it is reasonably satisfied that the borrower has not rescinded. Thus, while the Commentary regards the collection of interest as acceptable, there is always the possibility that some other law may forbid it.

A creditor may not always receive accolades for its restraint during the rescission period. In *Badie v. First Capital Mortgage Corp.*,¹¹¹ the creditor agreed to obtain credit life insurance for the consumer and pay the premium out of the loan proceeds.¹¹² The only problem was that the creditor delayed procuring the insurance until the expiration of the rescission period to see whether the consumer would sign an affidavit that he did not want to rescind the transaction.¹¹³ Unfortunately, the consumer died in the interim and was left without coverage.¹¹⁴ The consumer's disappointed spouse alleged breach of contract.¹¹⁵ She was hard pressed to explain, however, how the creditor could have paid the insurance company if the

108. 738 F. Supp. 1050 (E.D. Mich. 1990).

109. *Id.* at 1059.

110. *Id.* at 1060.

111. 576 So. 2d 191 (Ala. 1991).

112. *Id.* at 192.

113. The creditor correctly asserted that it was prohibited from using any of the loan proceeds to purchase the insurance during the three day rescission period until the debtor waived the right of rescission. *Id.* at 194.

114. *Id.* at 192.

115. *Id.* at 193.

premium was scheduled to come out of the loan proceeds, which had to remain untouched until the three-day period had expired.¹¹⁶ In executing the loan transaction, the creditor had certainly adhered to the letter of the law, leaving nothing to chance. The creditor had even provided for an affidavit of assurance that the consumer had not rescinded, in order to complete the transaction at the end of the rescission period.¹¹⁷ So precise was the arrangement between the parties that the creditor's responsibility to purchase the insurance out of the loan proceeds was conditioned upon the creditor's receipt of the affidavit.¹¹⁸ Even if the creditor had disbursed money to the insurance company in escrow,¹¹⁹ the insurance company hardly would have been willing to effect coverage since the consumer was not yet bound by the arrangement. The consumer could rescind and not be liable for any premium. Thus, even in its attempt to avoid problems of the *Morris* and *Curry* type, the creditor still was subjected to some grief. Nevertheless, the creditor stuck to the statutory script, even though it could not forecast this unique predicament.

D. Sale or Transfer of Property

It is clear that a sale or transfer of property terminates the right to rescind.¹²⁰ In ordinary circumstances, that would seem to be a mere transfer of ownership. However, in *Hefferman v. Bitton*,¹²¹ the Ninth Circuit Court of Appeals held that a consumer's rescission came too late because it followed, rather than preceded, the consumer's agreement to sell the property that was subject to the security interest.¹²² The court treated the "sale" as occurring at the time of contract rather than at closing of the

116. The creditor could not disburse funds to a third party because that would be premature performance. Commentary § 226.23(c)-1. It was understandable, therefore, that the insurance company would not cover the consumer without the necessary premium payment.

117. This was quite consistent with the example given in the commentary on how the creditor can satisfy himself that the consumer has not rescinded. See *id.* § 226.23(c)-4.

118. *Badie*, 576 So. 2d at 194.

119. The commentary provides that "[t]he creditor may disburse loan proceeds during the rescission period in a valid escrow arrangement." Commentary § 226.23(c)-2. This is consistent with the Regulation that "[u]nless a consumer waives the right of rescission . . . no money shall be disbursed other than in escrow" Regulation Z, 12 C.F.R. § 226.23(c). An escrow arrangement is not intended to obligate the consumer at that point.

120. TILA § 125(f), 15 U.S.C. § 1635(f); Regulation Z, 12 C.F.R. § 226.23(a)(3).

121. 882 F.2d 379 (9th Cir. 1989).

122. *Id.* at 384.

transaction.

The court rationalized its interpretation by recognizing the interest of Congress in avoiding clouds on titles.¹²³ But if the congressional policy is best fulfilled by treating the time of contract as the benchmark for the end of the rescission period, one wonders why Congress did not specifically use the term "contract of sale" rather than "sale." The court did not think it necessary to answer the question. However, by taking the approach that it did, the court really treated the contract of sale as the sale. One can only guess what would have happened if the consumer had been unable to fulfill his contract. Would the rescission notice then have been revived?

Arguably, a consumer's rescission between the date of contract and the date of closing has the potential for creating problems for the purchaser. The purchaser's major concern should be the lien affecting the property. In the ordinary course of events, liens affecting title would be satisfied or removed no later than closing; therefore, rescission of the original transaction would not give the consumer any unfair advantage in the ensuing sale transaction.¹²⁴ Although the Act prescribes the routine for implementing a consumer's rescission, a court has the flexibility to change the sequence of events to achieve the objective.¹²⁵ Therefore, even if the consumer's action has the potential for upsetting the sale of the property, the danger is minimal because the lender must take steps to remove the lien. Moreover, if the lender has reservations about doing that because of suspicions regarding the consumer, the lender can nevertheless seek judicial relief.

The parties may also need judicial help in sorting out matters if the consumer sells or transfers the property after giving timely notice, but before the lender is able to complete the formalities of rescission. In that event, the consumer's substantive right to rescind should still be available, but a court may have to use its equitable discretion to vary the process in the same way that it might do when a contract of sale is pending.¹²⁶

It should be noted that the rescission right will end even if the sale or transfer is not voluntary.¹²⁷ For example, it will end when there is a

123. *Id.*

124. Once the legal title remains with the consumer, the lender will still have its interests protected because the consumer will have to pay off the lender. The rescission may give the consumer a greater incentive to hasten the sale to the purchaser. This would be contrary to the court's point that the consumer might ask to delay the sale. See *id.*

125. TILA § 125(b), 15 U.S.C. § 1635(b); Regulation Z, 12 C.F.R. § 226.23(d).

126. There is no reason why a court's discretion to modify the procedure should not operate in this case. See *id.*

127. Commentary § 226.23(a)(3)-3.

foreclosure sale or a sale in which the consumer takes back a purchase-money mortgage or keeps legal title through an installment device.¹²⁸ If the consumer files for bankruptcy, that should not affect his rescission rights because such rights should terminate only if there has been a transfer of all the consumer's interest in the property.¹²⁹ Additionally, since the consumer will usually have some right of possession or a homestead exemption, the consumer will still have the right to rescind.¹³⁰ However, the consumer will have a right to rescind only if a right to grant a security interest existed.¹³¹ Therefore, if a consumer purports to grant a security interest in his property after filing for bankruptcy, his attempt to rescind thereafter will be unsuccessful because the security interest will be ineffective.¹³²

E. Refinancing and the Right to Rescind

The right of rescission does not apply to a "refinancing or consolidation by the same creditor of an extension of credit already secured by the consumer's principal dwelling."¹³³ However, rescission is available with respect to any new advances made in the refinancing to increase the outstanding loan.¹³⁴

Normally, a lender will refinance a transaction by extending new credit which pays off the outstanding loan and gives the consumer more money. Some creditors may inform their borrowers that the latter can rescind the entire loan because it is really a new transaction. However, the proper interpretation can be given to section 226.23(f) if one remembers that the basis for rescission is to give the consumer the opportunity to reflect on a transaction before subjecting his home to a lien.

For example, if the consumer's home already has a lien on it and the consumer seeks new funding, the rescission should be applied only to the extent of the new advance rather than to both the new advance and the old balance. The Board clarified this point in 1986 when it amended section 226.23(f)(2). As amended, the section provides that "[t]he right of rescission shall apply . . . to the extent the new amount financed exceeds the unpaid principal balance, any earned unpaid finance charge on the existing

128. *Id.*

129. NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING § 6.5.2.3 (1989).

130. *Id.*

131. *In re Crevier*, 820 F.2d 1553, 1556 (9th Cir. 1987).

132. *Id.*

133. Regulation Z, 12 C.F.R. § 226.23(f)(2).

134. *Id.*

debt, and amounts attributed solely to the costs of the refinancing or consolidation."¹³⁵

Despite the new language, there may still be room for confusion about the refinancing exemption. Several courts contend that the term "refinancing" should be applied only to a transaction that is "already secured" by a current mortgage, as distinguished from the new mortgage.¹³⁶ Thus, under this scenario there would be no refinancing if the lender satisfies an old mortgage and takes a new mortgage on the borrower's principal dwelling; in that event the borrower would have the right to rescind the entire new transaction. The lender in *In re Porter*¹³⁷ argued the point because the borrower was convinced that the lender had failed to distinguish between an old loan and a new advance secured by the same property. The lender must have been led astray by the Board's model rescission forms. One of them dealt only with the borrower's right to rescind the new transaction and left the original mortgage in place to protect the lender's lien. This form was not satisfactory to the lender because it was not applicable to the situation where the original mortgage was satisfied and replaced by another. The only other alternative therefore was another form which purported to give the borrower the right to rescind the entire transaction.¹³⁸ Having decided to cast its lot with the form that related more closely to the transaction at hand, the lender nevertheless found itself in a quandary. It advised the borrower that the borrower had a legal right to cancel "*this transaction*."¹³⁹ The lender had yearned for truth in lending but had managed to confuse the borrower.

The court in *Porter* knew full well that there was an ambiguity here that could not be ignored. What was the meaning of "*this transaction*" in this context? It could have been interpreted as a transaction for new money, thus giving the borrower the right to cancel that new arrangement.¹⁴⁰ Nevertheless, it would be understood that the old security interest would remain in effect, untouched by the vagaries of the new transaction.

On the other hand, it was quite possible for one to interpret the lender's notice as affecting both the old and new security interests, thus giving the

135. *Id.*

136. See, e.g., *In re Melvin*, 75 B.R. 952, 957 (Bankr. E.D. Pa. 1987); *In re Tucker*, 74 B.R. 923 (Bankr. E.D. Pa. 1987).

137. 961 F.2d 1066 (3d Cir. 1992).

138. It was a question of reconciling the Board's Model Form H-8 with Model Form H-9. See 12 C.F.R. pt. 226, app. H-9 (1992).

139. 961 F.2d at 1076.

140. *Id.* at 1077.

borrower the right to cancel the entire loan involving the old and new money.¹⁴¹ In this context, therefore, "this transaction" had a wider connotation and gave the borrower the right to wipe the slate clean.

The lender thought it was doing the borrower a favor by giving her the right to rescind both the old and new transactions, thus in effect depriving her of any basis for complaint. This would not necessarily have been a boon for the borrower, for the exercise of the rescission right carries with it the obligation to return the lender's money and the borrower might not have been able to do that.¹⁴² Thus the lender would not necessarily be right in assuming that the borrower would enjoy an advantage in rescinding both the old loan and the new advance. In this respect, the borrower may have been happy with a right of partial rescission.

In cases like *Porter*, the lender cannot afford to rely solely on the Board's model forms. The lender must be alert to the possibility that its transaction may require independent judgment about the form of disclosure required. One would have expected the Board's interest in providing the necessary guidance to lenders to lead the Board to some model covering these typical refinancing transactions. In *Porter*, the lender sought to attach a meaning to "refinancing" that could not be found in either the Act or the Regulation.

It is to be noted that section 226.23(f) covers not only a refinancing but also a consolidation and it is possible to interpret the latter as applying to a transaction that allows the current mortgage to remain in place, while recognizing the existence of the new transaction.¹⁴³ In any event, it is not necessary to interpret the Regulation so slavishly that the lender must retain precisely the same mortgage instrument as evidence of the security. There is nothing to be lost by recognizing the substance of the matter, which is that the lender will retain the same priority lien as security for the entire loan. If the creditor advances additional funds, however, the consumer's property would be subject to greater exposure and the Regulation therefore properly recognizes the consumer's right of rescission with respect to that amount.¹⁴⁴

141. *Id.*

142. *Id.* at 1077-78. The consumer has an obligation to return the creditor's property once the creditor has complied with his obligations. Regulation Z, 12 C.F.R. § 226.23(d)(3).

143. The right of rescission does not apply to "[a] refinancing or consolidation by the same creditor of an extension of credit already secured by the consumer's principal dwelling." Regulation Z, 12 C.F.R. § 226.23(f)(2). However, the right of rescission is applicable to any new advance. *Id.*

144. *Id.*

Although a consumer usually has a right to rescind beyond the normal three-day period because of the lender's delinquency, the lender may challenge that right if the consumer has refinanced the loan.¹⁴⁵ In *King v. California*, that challenge was successful because the court found that the new loan had superseded the original loan and that there was nothing left to rescind. Nevertheless, subsequent cases have taken the position that a consumer who has an extended right to rescind can do so as long as he acts no later than three years after consummation of the transaction.¹⁴⁶

It is noteworthy that paying off a loan is not listed in the Act or the Regulation as a ground for terminating the right of rescission. It is questionable therefore whether the payoff should be read into the Act and the Regulation as one of the terminating events when there seems to be no ambiguity. If the argument is that the rescission right affects only the security interest, and that a security interest no longer exists because the consumer has paid off the loan, then the argument misses the other important ingredients of rescission. The lender must not only remove the lien on the consumer's property, but it must also return any money or property that the consumer has given it.¹⁴⁷ Furthermore, the consumer is not liable for any finance or other charge in connection with the transaction.¹⁴⁸ Nevertheless, there may still be a compelling reason why the consumer wants to rescind the loan, even though he may have refinanced or otherwise paid it off. That reason may be solely financial, given the fact that the consumer stands to recover the finance charges and other costs involved in the transaction.¹⁴⁹

In addition, the consumer's remedy should not depend on whether the lender forgot to remove the lien from the record, for that would hardly affect the substance of the matter if the consumer has paid off the loan. The issue is whether the consumer should be able to rescind a loan that no longer exists. A similar question arises about a consumer's right to recover damages for a lender's faulty disclosures even though the consumer has

145. *King v. California*, 784 F.2d 910, 913 (9th Cir. 1986), *cert. denied*, 484 U.S. 802 (1987).

146. See, e.g., *Abele v. Mid-Penn Consumer Discount*, 77 B.R. 460, 464 (Bankr. E.D. Pa. 1987), *aff'd mem.*, 845 F.2d 1009 (3d Cir. 1988); *Mayfield v. Vanguard Sav. & Loan Ass'n*, 710 F. Supp. 143, 145 (E.D. Pa. 1989); *Steinbrecher v. Mid-Penn Consumer Discount Co. (In re Steinbrecher)*, 110 B.R. 155, 161 (Bankr. E.D. Pa. 1990).

147. TILA § 125(b), 15 U.S.C. § 1635(b); Regulation Z, 12 C.F.R. § 226.23(d)(2).

148. Regulation Z, 12 C.F.R. § 226.23(d)(1).

149. See RALPH J. ROHNER ET AL., *LAW OF TRUTH IN LENDING* § 8.03[2][a] & n.164.2 (Cum. Supp. 1989); NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 6.5.2.4.

already paid the loan. Perhaps it is easier to concede the consumer's right in the latter case because the damage has already been done. But the argument is also compelling if the right of rescission is implicated, for the consumer may need to save his home from the effects of an imprudent transaction. Therefore, the consumer's remedy should not hinge solely on the continued existence of the lien on his property, but rather on whether he is still within the prescribed time limit for rescinding.¹⁵⁰

If there is a series of refinancing transactions, there may be a question whether a Truth in Lending violation from one transaction will affect subsequent transactions. In *Steinbrecher v. Mid-Penn Consumer Discount Co. (In re Steinbrecher)*,¹⁵¹ the creditor failed to include the property insurance premium in the finance charge even though he did not disclose the necessary information about the insurance coverage.¹⁵² This delinquency resulted in an understatement of the finance charge and the annual percentage rate in the first transaction.¹⁵³ There were three refinancings resulting in a total of four loans and the proceeds of each loan were used in part to pay the prior outstanding loan.¹⁵⁴ The problem was that the creditor had miscalculated the rebate of unearned interest due from the first transaction when the loan was paid off simply because it had omitted the insurance cost and this error carried through to the three subsequent transactions. The court had little difficulty, therefore, in finding that the borrower had a right to rescind all four loans because the creditor had failed to disclose the correct finance charge and annual percentage rate in each of them.¹⁵⁵

150. In the same way that the legislation provides that the sale of the consumer's property terminates the right of rescission, TILA § 125(f), 15 U.S.C. § 1635(f), then it could have covered the continued existence of the loan. The absence of such a condition leaves the issue open to question.

151. 110 B.R. 155 (Bankr. E.D. Pa. 1990).

152. *Id.* at 163. Property insurance premiums may be excluded from the finance charge if the creditor discloses that the consumer may obtain coverage from someone of the consumer's choice. Regulation Z, 12 C.F.R. § 226.4(d)(2)(i). If the consumer gets coverage from or through the creditor, the premium for the initial term must be disclosed. *Id.* § 226.4(d)(2)(ii).

153. *Steinbrecher*, 110 B.R. at 164. The creditor must disclose the finance charge, using that term, and a brief description such as "the dollar amount the credit will cost you." Regulation Z, 12 C.F.R. § 226.18(d) (footnote omitted). The creditor must also disclose the annual percentage, using that term, and a brief description such as "the cost of your credit as a yearly rate." *Id.* § 226.18(e) (footnote omitted).

154. *Steinbrecher*, 110 B.R. at 158.

155. *Id.* at 165.

F. *Obligations of the Parties*

The consumer's rescission sets in motion a sequence of events. The statute nullifies the lender's security interest but requires the lender to take any necessary action to remove the lien from the record within twenty days.¹⁵⁶ At the same time, the lender must also return the consumer's property¹⁵⁷ and the consumer need not tender the lender's property until the lender has fulfilled its obligations.¹⁵⁸ Furthermore, the consumer may keep the property if the lender does not take possession of it within twenty days after the consumer's tender.¹⁵⁹

Although the sequence of events seems clear enough, difficulties arise when a creditor becomes concerned about a borrower's ability to meet its obligations. It is understandable that creditors would have this concern, for the secured creditor which loses its lien without any assurance of the borrower's compliance may find itself at a disadvantage. While the lien is in existence, the creditor can exert pressure on the borrower to perform. But when the borrower rescinds, the creditor's lien becomes automatically void and the creditor must act to clear the record.¹⁶⁰

A procedural problem may arise because a borrower does not have to indicate his reason for rescinding. As a result the creditor may find itself in a quandary if the borrower's rationale for rescinding is not clear. The creditor can perform and dispute the matter later, or it may immediately seek a declaration of rights to protect its interests.¹⁶¹ If the creditor performs and it does not take possession of his property within twenty days of the consumer's tender, the consumer may keep it without any obligation.¹⁶²

When the creditor does not act on the consumer's rescission, the consumer has no obligation to tender and the question frequently arises whether a forfeiture should be implied under such circumstances.¹⁶³ In

156. Regulation Z, 12 C.F.R. § 226.23(d)(1)-(2).

157. *Id.* § 226.23(d)(2).

158. *Id.* § 226.23(d)(3).

159. *Id.*

160. *Id.* § 226.23(d)(1)-(2).

161. See *Aquino v. Public Fin. Consumer Discount Co.*, 606 F. Supp. 504 (E.D. Pa. 1985); ROHNER, *supra* note 149, § 8.04[2][a], at S8-28.

162. Regulation Z, 12 C.F.R. § 226.23(d)(3).

163. The creditor should return any money or property and do what is necessary to reflect the termination of the security interest. Regulation Z, 12 C.F.R. § 226.23(d)(2). It is only after the creditor has complied with those requirements that the consumer must make his tender. *Id.* § 226.23(d)(3).

one sense, an implied forfeiture seems harsh, but it may be justified if the idea is to encourage the creditor to treat the consumer's rescission seriously. This provides a rather clear incentive for the creditor to act if it knows that its inaction may prove expensive in the long run.

Two recent cases illustrate the difficulty of dealing with the forfeiture provision. In *Celona v. Equitable National Bank (In re Celona)*,¹⁶⁴ the court took a rather straightforward view of the Regulation and read it as requiring a forfeiture unless the creditor could show some peculiar circumstance that exempted it from that fate.¹⁶⁵ This approach is commendable, for it spells out a seriousness of purpose in requiring the creditor to act lest it lose its property. Although there is provision for modifying the procedures by court order,¹⁶⁶ it seems reasonable that such modification should be reserved for special circumstances, thus lending further weight to the view that forfeiture should be the standard fare. The *Celona* court viewed forfeiture as the natural outcome of the creditor's conduct and did not subscribe to the view that a creditor should be overprotected in any way.

In *Mayfield v. Vanguard Savings & Loan Ass'n*,¹⁶⁷ it was a different story. The court decreed no forfeiture there, apparently because the consumer had made no tender. But the consumer has no obligation to tender until the creditor has performed. Since that tender obligation arises after the creditor has acted on the consumer's rescission, there is an explicit provision for forfeiture if the creditor does not take back its property within the appointed time.¹⁶⁸ There may also be a forfeiture when the creditor does not act, because unless it does so within the twenty-day period, the consumer has no obligation to tender.¹⁶⁹ It was surprising, therefore, that the *Mayfield* court would not allow the creditor's property to vest in the consumer because there was no tender.¹⁷⁰ In so doing, the court relied only on the explicit vesting right and did not consider the fact that the consumer could have benefitted from the implicit vesting which arises when the consumer has no tender obligation.¹⁷¹ Therefore, while *Celona* paid

164. 90 B.R. 104 (Bankr. E.D. Pa. 1988), *aff'd*, 98 B.R. 705 (E.D. Pa. 1989).

165. *Id.* at 113.

166. Regulation Z, 12 C.F.R. § 226.23(d)(4).

167. 710 F. Supp. 143 (E.D. Pa. 1989).

168. Regulation Z, 12 C.F.R. § 226.23(d)(3).

169. *Id.* § 226.23(d)(2)-(3).

170. 710 F. Supp. at 147.

171. *Id.* at 147-48; see also NATIONAL CONSUMER LAW CENTER, TRUTH IN LENDING § 6.10.2 (1989).

greater respect to the consumer's implicit right to retain the property, thus putting the burden on the creditor, *Mayfield* preferred to accept the doctrine that there should be no forfeiture of the creditor's property unless there were some special circumstances that dictated that result. The *Mayfield* court was so confident of its approach that it viewed the absence of the creditor's fraud or deceit as one count in the creditor's favor.¹⁷² This approach casts a different shadow on the right of rescission, for it protects the creditor as long as there is no evidence of other misconduct. However, there is no statutory requirement of such evidence for the creditor to suffer a forfeiture. The simple question is whether it has done what it was supposed to do. If it wishes to plead the equities of its case, there is a special provision for judicial modification.¹⁷³ But the presumption ought to be in favor of following the statutory procedure rather than offering routine modification.¹⁷⁴

Some courts have been persuaded that they should consider the relative equities of the parties or the benefit obtained by the consumer before fashioning an appropriate rescission remedy.¹⁷⁵ This has led to questionable conclusions about the statutory scheme. For example, in *Shepard v. Quality Siding & Window Factory, Inc.*,¹⁷⁶ the court conceded that neither creditor had performed its obligations, but the court felt compelled to consider whether the consumer had received any benefit from the improvement to her property. There was nothing unusual about this query because the rescission mechanism assumes some possibility of benefit to the consumer. That is why the consumer is expected to return the property

172. See 710 F. Supp. at 148. In *Reynolds v. D & N Bank*, 792 F. Supp. 1035 (E.D. Mich. 1992) the court simply stated that the statute does not contemplate allowing the consumer to retain the creditor's property just because the creditor does not respond. 792 F. Supp. at 1040. Nevertheless the court saw the possibility of forfeiture if the creditor ignored the court's order to do what it was supposed to do in the first place. The creditor therefore had two chances to follow the statutory procedure. The court preferred the approach of the court in *Rudisell v. Fifth Third Bank*, 622 F.2d 243 (6th Cir. 1980), which emphasized the equitable nature of the rescission remedy, rather than the hard-nosed approach of the court in *Celona v. Equitable Nat'l Bank (In re Celona)*, 90 B.R. 104 (1988), *aff'd*, 98 B.R. 705 (Bankr. E.D. Pa. 1989).

173. Regulation Z, C.F.R. § 226.23(d)(4).

174. See *Gill v. Mid-Penn Consumer Discount Co.*, 671 F. Supp. 1021 (E.D. Pa. 1987), *aff'd*, 853 F.2d 917 (3d Cir. 1988); *Celona v. Equitable Nat'l Bank (In re Celona)*, 90 B.R. 104 (1988), *aff'd*, 98 B.R. 705 (Bankr. E.D. Pa. 1989).

175. See *In re Gurst*, 79 B.R. 969 (Bankr. E.D. Pa. 1987); *Brown v. National Permanent Fed. Sav. & Loan Ass'n*, 683 F.2d 444 (D.C. Cir. 1982).

176. 730 F. Supp. 1295 (D. Del 1990).

obtained from the creditor. However, the court in *Shepard* did not see any problem with including the cost of labor in determining the benefit that the consumer had received through the installation of the siding on her home.¹⁷⁷ The court could find no rationale for excluding labor costs from the concept of "reasonable value." However, the reasonable value of the home improvements was not synonymous with the reasonable value of the property which the creditor had given to the consumer. The Regulation merely facilitates the consumer's accounting for the reasonable value of the property if the consumer would find it impracticable to return the property itself.¹⁷⁸

The *Shepard* court took comfort from the fact that when the Sixth Circuit in *Rudisell v. Fifth Third Bank*¹⁷⁹ remanded that case to the district court for a determination of "reasonable value," it did not give any directions for deducting the costs of labor. The *Rudisell* court might have thought it unnecessary to cover that point inasmuch as it was dealing with the reasonable value of "property."¹⁸⁰ If the purpose of rescission is to return the parties to the *status quo ante*,¹⁸¹ then it would be misleading to include the cost of labor in the calculations.¹⁸² The creditor would enjoy an advantage not contemplated by the statute. What would be the purpose of allowing rescission if the consumer has to pay for the creditor's handiwork? It is intended that the parties be restored to their original positions. The creditor should get back his property or the reasonable value thereof in appropriate circumstances. It is only by taking this approach that courts will be able to provide incentive for creditors to comply with the

177. *Id.* at 1307 n.20. It would be a strange construction indeed for the labor cost to come within the definition of "property." The court thought it strange that the consumer did not cite any authority for her view that labor cost should be excluded. *Id.* All that she needed to do, however, was to look to the language of the Regulation which required her to tender the property or "its reasonable value." See Regulation Z, 12 C.F.R. § 226.23(d)(3).

178. See Regulation Z, 12 C.F.R. § 226.23(d)(3).

179. 622 F.2d 243 (6th Cir. 1980).

180. See *id.* at 254. The *Rudisell* court would have gone out of its way in dealing with the costs of labor because such costs had nothing to do with "property." Therefore, the *Shepard* court read too much into the *Rudisell* court's failure to deduct the labor costs.

181. See *James v. Home Constr. Co.*, 621 F.2d 727, 730 (5th Cir. 1980).

182. See *Tri-West Constr. Co. v. Hernandez*, 607 P.2d 1375, 1381 (Or. Ct. App. 1979) (defendants required to tender either original personal property items provided by plaintiff in connection with home improvements or reasonable value of this property, but not reasonable value of services furnished). If a creditor is able to recover his labor costs, he has really imposed the contract on the consumer, at least to the extent of his performance. That would seem to run counter to the purpose of rescission.

statutory requirements. Creditors should have to plead their case to secure equitable relief on account of special circumstances.

III. SECURITY INTERESTS: IDENTIFICATION

A creditor must disclose the existence of any security interest in property which the borrower is purchasing as part of the transaction and in the case of other property, he must identify the security by item or type.¹⁸³ A security interest does not include incidental interests, interests in after-acquired property, or security interests that arise by operation of law (except for purposes of rescission).¹⁸⁴ Some creditors experience problems not in recognizing a security interest, but rather in employing the proper terminology required by the Regulation.

When a creditor identifies a security interest differently in the security agreement and the disclosure statement, the resulting ambiguity may lead to a Truth in Lending violation. A good example occurred in *Doubet v. U.S.A. Financial Services, Inc.*,¹⁸⁵ when the agreement gave the creditor a security interest in consumer goods then owned by the borrower, whereas the disclosure statement identified the collateral by item.¹⁸⁶ There was a clash here between an overinclusive clause in the security agreement and the itemized list in the disclosure statement. If the agreement purported to give a security interest in all the consumer's goods, the statement could hardly do less. It was left to conjecture whether the listing accounted for all the borrower's goods. The creditor could have resolved that doubt by making the language in the disclosure statement as broad as that in the security

183. Regulation Z, 12 C.F.R. § 226.18(m).

184. *Id.* § 226.2(a)(25).

185. 714 F. Supp. 980 (C.D. Ill. 1987).

186. The disclosure statement gave a security interest in a "Quazar 25 inch color console television, Quazar VCR, McDonald receiver, Soundtech tape player, Soundtech speakers, 22 inch push lawnmower, and 1981 homemade flat bed trailer." *Id.* at 983. The security agreement covered collateral described as:

Consumer goods now owned or hereafter acquired within 10 days of the date of this loan or any future loan, by the Borrower(s) in replacement of such consumer goods (and proceeds) now or hereafter located in or about the residence of the Borrower(s) above set forth including those items described on Schedule A, if such Schedule A is attached hereto, together with such non-consumer goods as described on Schedule A.

agreement.¹⁸⁷

The lender explained the inconsistency by treating the language in the security agreement as an after-acquired property clause because the language covered "consumer goods now owned or hereafter acquired within ten days." It was not difficult for the court to separate the after-acquired property provision from the other provision covering the consumer's current goods. Therefore, although the lender did not have to disclose an after-acquired property clause because it was not a security interest under Truth in Lending,¹⁸⁸ that did not help the lender in this situation because the clause in the security agreement was clearly divisible.

There was a slight variation on the theme in *In re Stoneking*.¹⁸⁹ The security agreement covered the borrower's consumer goods, including specific items listed in a schedule, while the disclosure statement specifically mentioned the items only.¹⁹⁰ The court took the view that the use of the word "include" with respect to the items in the schedule suggested that the security agreement covered more than such items. If the parties had intended to restrict the security interest to the items in the schedule, the agreement would have used language of limitation.¹⁹¹ Thus, by using language of inclusion in the security agreement, the lender in *Stoneking* seemed to put itself in a less defensible position than the lender in *Doubet*. The lender in *Doubet* may have had an argument that the items in the disclosure statement were all the consumer goods that the borrower owned. There was an element of ambiguity in *Doubet* that was lacking in *Stoneking*. Nevertheless, the lesson remained the same; the security agreement and the disclosure statement must carry the same message about the applicable security interest.

The creditor may be in a quandary if he refinances a purchase-money loan and secures the new loan with the same collateral. In *In re Hatfield*,¹⁹² the creditor disclosed that the new loan was secured by the

187. The court said that "[i]f the creditor had intended to take a security interest in only those items described in the Federal Disclosure Statement, then that should have been made clear on the Note and Security Agreement." *Id.* at 985; see also *Teel v. Thorp Credit, Inc.*, 609 F.2d 1268 (7th Cir. 1979) (note and security agreement described much broader security interest than disclosure statement).

188. *Doubet*, 714 F. Supp. at 985 (citing comment 18(m)-4 of Official Staff Commentary).

189. 99 B.R. 892 (Bankr. C.D. Ill. 1989).

190. *Id.* at 895.

191. *Id.*

192. 117 B.R. 387 (Bankr. C.D. Ill. 1990).

make any immediate purchase with their new funds.

It is a clear lesson that the need to provide the consumer with Truth in Lending disclosures cannot be obscured with the demands of other statutory schemes. Although the consumers in *Hatfield* must have felt some discomfort with the seemingly inconsistent analysis, the court's characterizations were not irreconcilable. The lender had a duty under Truth in Lending to let the consumers know which property was subject to its lien and it could not realize that objective by the simple designation of "goods being purchased."¹⁹⁸ Since the consumers had already bought the goods, such a designation hurt, rather than helped the lender's cause. On the other hand, the court's purchase-money designation for bankruptcy purposes recognized the lender's infusion of capital for purchase of the goods.¹⁹⁹ Therefore, it was not a question of misleading the consumers about the nature of the security, but rather one of respecting the lender's priority in the scheme of things if the new loan was really a refinancing with hardly a change in terms, except for a reduction in monthly payments.²⁰⁰

Another conflict surfaced in *In re Dingleline*.²⁰¹ The lender listed eight items as collateral in the security agreement but merely described them in the disclosure statement as "certain household items."²⁰² The lender could not be faulted for attempting a description of the property by type, for the Act specifically requires that in loans that are not purchase-money transactions.²⁰³ Nevertheless, the consumer was doubtful that "certain household items" included property such as a bicycle and fishing equipment,

198. *Id.* at 390.

199. The debtors wanted to avoid the lender's lien under § 522(f) of the Bankruptcy Code. The issue was whether the refinancing was merely a renewal of the original obligation or a novation. *Id.* at 390. The court's test was whether the debtor's original obligation had changed, such as taking an additional loan. *Id.*; see also *In re Gayhart*, 33 B.R. 699 (Bankr. N.D. Ill. 1983).

200. *Hatfield*, 117 B.R. at 390. Even when there is an additional advance, some courts still find it possible to recognize the original purchase-money transaction. See *In re Russell*, 29 B.R. 270 (Bankr. W.D. Okla. 1983); *In re Moore*, 33 B.R. 72 (Bankr. D. Or. 1983); see also ROBERT E. GINSBERG, BANKRUPTCY: TEXTS, STATUTES, RULES § 6.02(c), at 498 (Supp. 1991).

201. 916 F.2d 408 (7th Cir. 1990).

202. *Id.* at 409. The security agreement described the security as follows: "camera, fishing equipment, bicycle, hoses, portable grill, cassette recorder/player, radio, VCR." *Id.*

203. *Id.* at 410. The Regulation requires the following disclosure: "The fact that the creditor has or will acquire a security interest in the property purchased as part of the transaction, or in other property identified by item or type." Regulation Z, 12 C.F.R. § 226.18(m).

which were among the collateral that was clearly itemized in the security agreement.²⁰⁴ In the consumer's view, therefore, the disclosure statement was inaccurate and incomplete, for it did not match the items specified in the security agreement.

Here again, the resolution of the conflict lay in deciphering the different objectives of the Truth in Lending Act and the Bankruptcy Code. The court took the view that the Act's description of "household items" was broader than the description of "household goods" in section 522(f) of the Bankruptcy Code and that the lender's disclosure in its statement of the property listed in the security agreement as "certain household items" included a bicycle and fishing equipment.²⁰⁵ Therefore, the narrow definition that would be given to "household goods" in section 522(f) by including only these items that were required for the debtor's household was not applicable to the Act's treatment of "household items."²⁰⁶ The court relied on the Commentary's recognition that "certain household items" and "household goods" were two distinct categories.²⁰⁷ In this way, the court could fit the items in the security agreement within the category of "certain household items," without disturbing the narrow definition contemplated for "household goods" in section 522(f) of the Bankruptcy Code.

IV. FINANCE CHARGE

A. *The Hidden Charge*

An important feature of the Act is that the creditor must tell the consumer the cost of credit by disclosing the finance charge.²⁰⁸ The difficulty lies, however, in identifying the finance charge, because it may

204. *Dingledine*, 916 F.2d at 410.

205. *Id.* at 411.

206. *Id.* at 410. "Under the Bankruptcy Code, 'household goods' are defined in specific language in order that it might prevent insolvent debtors from avoiding liens on personal items of property other than those essential for the day-to-day operation of a household." *Id.*

207. *Id.* The Commentary advises that the disclosure of a non-purchase money security interest can be made by "a general disclosure of the category of property subject to the security interest, such as 'motor vehicles,' 'securities,' 'certain household items,' or 'household goods.'" Commentary § 226.18(m)-2. The court dealt with the meaning of "certain household items" but regarded the term as different from "household goods." *Dingledine*, 916 F.2d at 411.

208. 15 U.S.C. § 1601(a) (1992).

involve more than interest. The Regulation defines a finance charge as "any charge payable directly or indirectly by the consumer . . . as an incident to or a condition of the extension of credit."²⁰⁹ This definition is broad indeed and it includes many charges that the consumer has to pay in order to consummate the transaction.²¹⁰ Its scope is not surprising because the congressional objective was to give consumers an accurate idea of financing costs so that consumers could make informed decisions.²¹¹

It was recognized early that creditors could bury "the cost of credit in the price of goods sold."²¹² Creditors could accomplish this by merely including any finance charge in the cost of doing business and setting the price accordingly. The Federal Reserve Board recognized this possibility when it applied its Regulation to transactions that were payable in more than four installments.²¹³ When a creditor challenged the four-installment rule in *Mourning v. Family Publications Service, Inc.*,²¹⁴ it seemed confident that the Board had exceeded its mandate since the congressional statute required disclosures only when the creditor imposed a finance charge.²¹⁵ The creditor's view was that Congress had intended to restrict the Board by requiring disclosure in certain transactions.²¹⁶

It was clear to the Court that Congress did not intend to list in the Act

209. Regulation Z, 12 C.F.R. § 226.4(a).

210. See *id.* § 226.4(b) for examples of the finance charge. This § includes not only interest but service charges and points. *Id.*

211. The first § of the Act discloses the congressional findings and declaration of purpose:

The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of [the] subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing and credit card practices.

TILA § 102(a), 15 U.S.C. § 1601(a).

212. *Mourning v. Family Publications Serv., Inc.*, 411 U.S. 356, 366 (1973).

213. One of the criteria for regulatory coverage is that "the credit is subject to a finance charge or is payable by a written agreement in more than four installments." Regulation Z, 12 C.F.R. § 226.1(c).

214. 411 U.S. 356 (1973).

215. Pub. L. No. 93-495, § 146, 88 Stat. 1500, 1517 (1974) added a provision dealing with payment in more than four installments.

216. *Mourning*, 411 U.S. at 372.

all transactions to which the Board's Regulation might apply, for the Court knew full well that Congress could not foresee all the possible subterfuges of creditors.²¹⁷ Nevertheless, the Board had to use its power as the implementing agency to deter creditors from engaging in conduct that would prevent consumers from comparing credit terms. The question was whether the four-installment rule was reasonably related to congressional objectives. There was ample evidence that creditors would use a loophole of this type to collect a finance charge that was not specifically identified. Additionally, the Court did not believe the rule to be deficient simply because some creditors, who did not include a finance charge in an extended payment plan, might be subjected to it.²¹⁸

It did not take long for the four-installment rule to prove its worth. For example, in *Killings v. Jeff's Motors, Inc.*,²¹⁹ the consumer agreed to pay \$1805.28 in twenty-four installments for a used car which the seller had previously bought for \$760. The seller indicated on its disclosure statement that it was imposing no finance charge.²²⁰ The parties stipulated that the average retail price listed in the used car guide for that type of car was \$1,780.²²¹ The buyer appealed the award of minimum statutory damages. The Fifth Circuit Court of Appeals was sympathetic to the buyer's claim that the finance charge could be readily ascertained despite the lower court's inability to fix the same.²²² The appellate court relied on the difference between the going retail price in the marketplace and the cash price paid by the buyer.²²³ The consumer was vindicated, for just as she alleged, the creditor had buried its finance charge in the cash price and the generous installment arrangement did not tell the full story.

In *Killings*, the parties agreed on the average retail price for cars of the type in dispute.²²⁴ When there is a substantial difference between the market price and the sales price and the parties cannot agree on the market price, the consumer must still produce evidence of the disparity. In *Vines v. Hodges*,²²⁵ the court was mindful of the stipulation in *Killings* concerning the average retail price, but it did not rush to accept the *Killings*

217. *See id.*

218. *Id.* at 374.

219. 490 F.2d 865 (5th Cir. 1974).

220. *Id.* at 865.

221. *Id.*

222. *Id.* at 866.

223. *Killings*, 490 F.2d at 866.

224. *Id.* at 865.

225. 422 F. Supp. 1292 (D.C.C. 1976).

formula. There was no stipulation in *Vines* and it was conceivable that the particular used car under consideration could have brought more than the average price.²²⁶

The tendency to regard the creditor's profit over the actual value as a finance charge can create some problems. If the creditor charges cash customers and credit customers the same price, then it is arguable that the creditor has included its costs and its profit in its price of the goods. If the creditor sets a price for all customers that includes the creditor's overhead and profit, it is difficult to require the creditor to apportion those items to each credit customer as a finance charge.²²⁷ Nevertheless, in *Lawson v. Reeves*,²²⁸ the Supreme Court of Alabama was persuaded that there must be a hidden finance charge somewhere "when the installment sales contract does not disclose an annual percentage rate, but the stated price exceeds the actual value of the item sold."²²⁹ The *Lawson* court took its lead from the Fifth Circuit's decision in *Killings*, on the erroneous conclusion that *Killings* had affirmed the lower court's finding that there was an undisclosed finance charge.²³⁰ However, although the district court in *Killings* found that such a charge existed, the creditor did not appeal that finding. Therefore, the *Lawson* court should not have looked to the Fifth Circuit's decision to support the view that there is a hidden finance charge whenever the sales price exceeds the actual value of the item. The Fifth Circuit had only to face the question of the amount of the finance charge.²³¹

Sometimes a court will find its patience tested by a creditor's excessive mark-up, and as a result, will speedily identify a hidden finance charge. The question then becomes whether a court should use Truth in Lending to regulate the price that a seller may charge. This scenario is different from the case where the consumer agrees to pay in installments but the creditor

226. *Id.* at 1300.

227. The Official Staff Commentary refers to the costs of doing business in this way:

Charges absorbed by the creditor as a cost of doing business are not finance charges, even though the creditor may take such costs into consideration in determining the interest rate to be charged or the cash price of the property or service sold. However, if the creditor separately imposes a charge on the consumer to cover certain costs, the charge is a finance charge if it otherwise meets the definition.

Commentary § 226.4(a)-2.

228. 537 So. 2d 15 (Ala. 1988).

229. *Id.* at 17.

230. *Id.*

231. *The Hidden Finance Charge Reappears to Haunt Sellers*, CONSUMER CREDIT & FINANCE REP., May 1989, at 5.

discloses that there is no finance charge involved. In the excessive mark-up case, the creditor will disclose a certain finance charge, but the consumer may claim that the finance charge disclosed is far less than the real finance charge.

In *In re Stewart*,²³² the purchasing retailer bought his goods from another retailer and then sold them on credit at a mark-up of over 100%. Then the selling retailer disclosed his finance charge on the basis of the new price, and that charge came to an annual rate of eighteen percent. The retailer justified the price on the ground that it was selling on credit to people who were poor credit risks and that it had to sell merchandise at a profitable price. The retailer could not sell at the same price as its supplier because the supplier sold for cash. Nevertheless, the court found that the creditor had overreached in this case.²³³ The court was impressed by the fact that the consumers could have obtained the same goods for cash at less than half the price from the seller's supplier.²³⁴

The court was keen on requiring the creditor to disclose as its cash price the figure which retailers were using to sell their goods for cash.²³⁵ In the court's view, anything in excess was in reality the cost of credit and therefore had to be disclosed as a finance charge.²³⁶ Therefore, the seller had violated Truth in Lending requirements by not disclosing the full finance charge. The court seemed disturbed because the seller had exacted an unconscionable markup from the consumer and felt that it was necessary to look behind the disclosures to determine the seller's true profit.²³⁷

However, public policy considerations cannot be ignored. It is not unusual for creditors to impose high selling prices in certain inner-city areas; however, the court felt that it had to make a point that there was a limit to the prices that a seller could charge in a credit transaction, even in those areas where credit was not readily available.²³⁸

On the other hand, one must ask whether a seller, like the one in *Stewart*, provides such a valuable service to purchasers who cannot pay cash that courts must be more tolerant of their financing schemes. The only real test of the available cash price would be to have the seller engage in a few cash sales. When the seller is a credit specialist, it is difficult to show

232. 93 B.R. 878 (Bankr. E.D. Pa. 1988).

233. *Id.* at 884.

234. *Id.* at 885.

235. *See id.* at 886.

236. *Id.*

237. *Stewart*, 93 B.R. at 888.

238. *Id.* at 883-84.

that the sales price is the product of an excessive markup. Nevertheless, some courts feel justified in examining the differential between the seller's cost and the seller's price. As a matter of public policy, courts will doubtless be persuaded that there is a line that the creditor must not cross even if it means that certain consumers will be shut out of the marketplace.²³⁹

There is a difference, however, between selling at an abnormally high price to mask a finance charge and selling a defective item at a regular market price. In the latter case, if the consumer is dissatisfied with his purchase, his remedy really lies under a warranty theory rather than Truth in Lending. That did not stop the consumer in *Frazee v. Seaview Toyota Pontiac, Inc.*²⁴⁰ from seeking a Truth in Lending remedy because her newly purchased car would not work. The consumer asked the court to recognize the difference between the fair market value and the purchase price of the defective car as a hidden finance charge. The court would not extend the approach of cases like *Killings* and *Vines*, because in those cases the problem was not dissatisfaction with the goods. It was a question of determining if the creditor's finance charge was included in the inflated price despite the creditor's assurance that there was none.²⁴¹

In *Frazee*, the court would not grant the consumer any solace for her bad bargain, at least not through the Truth in Lending vehicle she desired. There was no evidence of an exorbitant price but the consumer was certainly upset with the bargain that she had struck. Nevertheless, it was an occasion for the court that remind the parties that Truth in Lending is a disclosure statute and not a device for salvaging bad bargains.²⁴²

It is at least understandable that a person will want to use Truth in Lending to protect his bargaining position in a genuine dispute. However, there is no requirement that there be any dispute between the parties before a consumer can invoke a Truth in Lending remedy. Therefore, a debtor can very well concede that he owes a debt while seeking such a remedy against the person whom he owes. It is not startling that a person may be anxious to reject the label of "creditor" in that context on the ground that the debt due him does not carry a finance charge or that is not payable by written agreement in more than four installments. But the person's desire to avoid

239. The court in *Stewart* viewed the transaction as "representative of the worst sort of exploitive tactics." *Id.* at 879.

240. 695 F. Supp. 1406 (D. Conn. 1988).

241. *Id.* at 1408.

242. *Id.*

the label may be complicated by the fact that the debtor may spread out his payments on his own initiative in the face of the other party's constant demand for payment. The debtor's failure to pay promptly creates a doubt about the arrangement between the parties and that is all the debtor needs to suggest the application of the disclosure requirements.

In *Porter v. Hill*,²⁴³ a lawyer billed his client periodically and requested payment in full each time. Both the parties' agreement and the billing statement imposed a late payment charge if the client did not pay the total balance within thirty days. The only problem was that the debtor defaulted but the lawyer did not sue right away. The latter merely added on the late charge and kept up his billing. Eventually the lawyer could not stand it any longer and brought a collection action. The client counterclaimed for a breach of Truth in Lending. The court took note of several points. The parties' written agreement required payment "in advance, or upon billing by Attorney."²⁴⁴ This understanding was therefore inconsistent with the definition of credit, which gives the debtor the right to defer payment.²⁴⁵ Therefore the debtor's action in stretching out the payments did not turn the lawyer into a creditor.²⁴⁶ More importantly, both the agreement and the billing statement identified the extra charge which the lawyer collected as a late payment charge²⁴⁷ rather than a finance charge. The debtor could have avoided such a charge by simply paying off the amount due within the thirty-day period. This was a case where compassion for the debtor may have come back to haunt the lawyer. In the end, his patience was rewarded but it underscores the need for vigilance in avoiding the finance charge label or the pitfall of having the parties' arrangement recognized as one that calls for payment in more than four installments.

When the creditor imposes a flat fee for a late payment, there should be little difficulty in rejecting it as a finance charge. In *Hahn v. Hanks Ambulance Service, Inc.*,²⁴⁸ though, the Eleventh Circuit had some concern when the creditor categorized the charge as a time price differential. It was

243. 838 P.2d 45 (Or. 1992).

244. *Id.* at 51.

245. Regulation Z defines credit as "the right to defer payment of debt or to incur debt and defer its payment." Regulation Z, 12 C.F.R. § 226.2(a).

246. A creditor is a person who regularly extends consumer credit that is subject to a finance charge or that is payable by written agreement in more than four installments. Regulation Z, 12 C.F.R. § 226.2(a)(17)(1).

247. Late payment charges are excluded from the finance charge. Regulation Z, 12 C.F.R. § 226.4(c)(2).

248. 787 F.2d 543 (11th Cir. 1986).

anybody's guess why this particular label was chosen, for it is one that usually refers to deferment of the debt. Nevertheless, the company wanted to provide some incentive for the debtor to pay promptly and to provide for the increased cost of carrying the overdue debts. The court did not recognize the charge as a finance charge but it was a close call in light of the company's label, "time pay price differential."²⁴⁹

B. Fees

The definition of "finance charge" has caused some concern from time to time because of its broad scope.²⁵⁰ No doubt it reflects the congressional will to include any charge that is remotely attached to the credit transaction.²⁵¹ Nevertheless, there is always that nagging question whether a particular charge can be legitimately characterized as one imposed directly or indirectly by the creditor. It is a tricky problem but it is helpful to query whether the creditor would make the loan if the charges in question were not paid.

This issue is particularly prevalent with attorney's fees. In *First Acadiana Bank v. Federal Deposit Insurance Corp.*,²⁵² the creditor required the borrower to use a bank-approved attorney to prepare a chattel mortgage on an automobile, the security for the loan. The attorney always set the fee, which the bank then included in the amount financed but not in the finance charge. The court held that the attorney's fee should be included in the finance charge²⁵³ because it was a charge "incident to the extension of credit."²⁵⁴

249. See *id.* at 544; see also *Bright v. Ball Memorial Hosp. Ass'n*, 616 F.2d 328 (7th Cir. 1980).

250. The finance charge includes "any charge payable directly or indirectly by the consumer and imposed directly or indirectly by the creditor as an incident to or a condition of the extension of credit." Regulation Z, 12 C.F.R. § 226.4(a).

251. Truth in Lending captures the all-inclusive nature of a finance charge with the language: "sum of all charges, payable directly or indirectly." TILA § 106(a), 15 U.S.C. § 1605; see also RALPH J. ROHNER, LAW OF TRUTH-IN-LENDING § 3.02[1] (1984).

252. 833 F.2d 548 (5th Cir. 1987).

253. The amount financed is obtained by: "(1) Determining the principal loan amount or the cash price (subtracting any down payment), (2) Adding any other amounts that are financed by the creditor and are not part of the finance charge, and (3) Subtracting any prepaid finance charge." Regulation Z, 12 C.F.R. § 226.18(b).

254. 833 F.2d at 550 (attorney's fee is not "of a type payable in a comparable cash transaction" since there would be no chattel mortgage in a cash transaction, and therefore no attorney's fee for preparing such a document); see also *Berryhill v. Rich Plan*, 578 F.2d

The bank also tried to avoid any disclosure obligation because the attorney set the fee and retained it. However, there has never been a requirement that the creditor must keep the fees that are assessed as a condition of granting credit.²⁵⁵ Both the Act and the Regulation recognize the possibility of the direct or indirect imposition of a charge²⁵⁶ and therefore, the mere fact that the charge ends up in the hands of a third party does not detract from the condition attached to the loan that the consumer must pay the charge for the loan to be made. The important element here is that the creditor required the services to be rendered by a third party. If the creditor does not require such services, the third party's fee is not a part of the finance charge if the creditor does not keep it.²⁵⁷

It is not always easy to determine whether a charge has been imposed as a condition of the extension of credit. The easiest case is when the creditor will not grant a loan unless the consumer pays a certain charge. Some cases are not that clear. For example, in *Pendleton v. American Title Brokers, Inc.*,²⁵⁸ the consumer pledged his car to the defendant in exchange for a loan. In order to have the continued use of his car, the consumer rented the car back from the defendant, paying a weekly rental of 10% of the loan amount. The court found that this weekly rental was a finance charge despite the fact that the consumer was not compelled to lease back her car as a condition of obtaining credit.²⁵⁹ The court characterized the charge as one imposed "incident to the extension of credit."²⁶⁰ The loan and the lease were part and parcel of the same transaction and the rental was not tied to anything other than the loan amount. The lender thought that it could avoid liability by showing that it did not impose the lease-back arrangement on the consumer as a condition of the loan. Nevertheless, it was significant that ninety percent of the consumers rented their vehicles back from the lender and the latter fully expected the consumers to be attracted to the lend-lease arrangement. Therefore, while the court

1092, 1099 (5th Cir. 1978); Regulation Z, 12 C.F.R. § 226.4(a).

255. The Commentary states that "charges imposed on the consumer by someone other than the creditor are finance charges (unless otherwise excluded) if the creditor requires the services of the third party." Commentary § 226.4(a)-3.

256. *Id.* § 226.4(a).

257. *Id.* § 226.4(a)-3.

258. 754 F. Supp. 860 (S.D. Ala. 1991).

259. *Id.* at 863.

260. *Id.* at 864.

back²⁶¹ as incident to the extension of credit. It was all one package and the lender therefore had to tell the real story of the cost of this "auto pawn."

There are some transactions which provide some comfort for creditors because from their perspective the transactions produce profit without a hidden finance charge. A consumer will frequently feel some uneasiness when he learns about a discount arrangement between his original creditor and an assignee. Although discounts are a fact of commercial life, a consumer may feel that the discount figure should be disclosed to him as a part of the finance charge because the creditor-assignor takes that feature into account in negotiating the transaction with the consumer.

In *April v. Union Mortgage Co.*,²⁶² the consumers agreed to pay a contractor \$20,000 as the cash price for work to be done. The consumers later refinanced the loan through Union Mortgage and used the proceeds to pay off the contractor and other parties. Union Mortgage paid the contractor only \$16,700 rather than \$20,000, thus benefitting from a discount of \$3,300 which the consumers claimed should have been disclosed as a finance charge.

It was no surprise that the consumers did not prevail. The court took the view that charges which a creditor assumes as a cost of doing business are not a part of the finance charge even though the creditor takes such charges into account in setting his terms.²⁶³ Furthermore, the court found that a discount in connection with an assignment is not a finance charge unless the discount is separately imposed on the consumer.²⁶⁴ Even though the contractor encouraged the consumer to refinance through Union Mortgage and pay him off, that was no different from a mere assignment from the contractor to Union Mortgage with respect to the treatment of the discount.

A discount of this type is very much like another kind of charge known as seller's points that a seller sometimes pays to a lender for making a loan to a buyer.²⁶⁵ The rationale for not treating such seller's points as a

261. The lender's newspaper advertisement read: "'Pawn your title, keep your car.'" *Id.* at 861. The lender had in mind the idea of lending money to the borrower on the security of the automobile and then renting the automobile back to the borrower as a simultaneous transaction. *Id.* at 864; see also *Pawn Your Title: Keep Your Car*, 10 NCLC REP. 25, 27 (1991).

262. 709 F. Supp. 809 (N.D. Ill. 1989).

263. *Id.* at 813; see also Commentary § 226.4(a)1-2.

264. *April*, 709 F. Supp. at 813; see also Regulation Z, 12 C.F.R. § 226.4(b)(6).

265. Regulation Z, 12 C.F.R. § 226.4(c)(5); *Finance Charge for a Loan to Pay off Installment Purchases*, CONSUMER CREDIT & TRUTH-IN-LENDING COMPLIANCE REP., Aug.

finance charge is that they are imposed on the seller and not on the buyer, and that is the position even though the seller may increase his price to account for the possibility of paying this charge.²⁶⁶

In *April*, the mortgage company did not require the contractor to pay any charge or points directly to the company. However, the contractor had to accept a discounted price for the installment contract that he had made with the consumer and that put the contractor in the position of a seller in the normal sales-financing transaction. The discount was no more a finance charge than seller's points.²⁶⁷

There are other ways in which a creditor may increase its yield without running afoul of the disclosure provisions affecting the finance charge. Sometimes a creditor will require the consumer to deposit funds with it as a condition of granting the loan. If the creditor reduces the interest rate on the loan as a result of the consumer's deposit, such an escrow account is an additional finance charge because it is used to buy a lower rate.²⁶⁸

However, there are variations on the theme which do not produce a finance charge. One example is the payment escrow account which was used in *Therrien v. Resource Financial Group, Inc.*²⁶⁹ The creditor required the consumer to deposit \$11,846.24 from the loan proceeds into a payment escrow account for the payment of the first sixteen payments on the loan. The creditors paid the consumer five percent per annum on the payment escrow. The consumers believed that the creditor had violated Truth in Lending by not disclosing the amount of \$11,846.24 as a finance charge, thus extending the period in which the consumers could rescind the loan.

The court took the view that the payment escrow account was a required deposit rather than a finance charge.²⁷⁰ It noted that the escrow account still belonged to the consumers and that the creditor had paid the

1989, at 6 [hereinafter *Finance Charge*].

266. Commentary § 226.4(c)(5)-1. If a non-creditor seller pays a commitment fee to a creditor, it should be treated as seller's points. However, points paid by the buyer to the creditor are part of the finance charge. *Id.*

267. *April*, 709 F. Supp. at 813; see also *Finance Charge*, *supra* note 265, at 6.

268. The Commentary explains this arrangement as a consumer buy down. The creditor must disclose the terms of the buy down agreement. The amount the consumer pays may be deposited in an escrow account or kept by the creditor. Commentary § 226.17(c)-4.

269. 704 F. Supp. 322 (D.N.H. 1989).

270. *Id.* at 326. If the creditor insists on a required deposit, the creditor must provide a statement that the annual percentage rate does reflect the effect of the required deposit. Regulation Z, 12 C.F.R. § 226.18(a). Commentary § 226.18(r)-1.

consumers interest on the account which was segregated in the consumers' name.²⁷¹ That was, therefore, a sign that the money was for the benefit of the consumers. If the account was a finance charge, then the creditor could commingle the funds and use them as its own. The escrow account was not used to buy a better interest rate but to make the monthly payments as they matured. It was, therefore, like a pledged account mortgage which allows a creditor to withdraw sums from the account to supplement the consumer's monthly payments.²⁷²

The court in *Therrien* expressed some discomfort with the arrangement because the consumers actually borrowed more money than they needed, especially when the interest rate was 20.25% and the consumers' escrow account earned only five percent.²⁷³ It was a way for the creditor to increase the loan amount, and thus the interest earned, without parting with a significant part of the loan proceeds. In this respect, it was different from a deposit that sits in an account as a trade-off for a preferential interest rate. However, Truth in Lending does not require that a loan be fashioned to the consumer's advantage, but only that there be an accurate disclosure of the credit terms. In this respect, it is comforting that the Regulation requires the creditor to inform the consumer that the annual percentage rate on the loan does not take into account the required deposit arrangement.²⁷⁴ At least in such circumstances, the consumer should know that the loan may be costing him a little more than he had anticipated.

Certain charges are excluded from the finance charge if they are itemized and disclosed. Among them are taxes and fees which are paid to public officials for perfecting, releasing, or satisfying a security interest.²⁷⁵ The creditor may either disclose such charges as a lump sum or itemize them according to the specific fees or taxes imposed.²⁷⁶ If a creditor imposes other charges on a customer that do not fall within the itemization

271. *Therrien*, 704 F. Supp. at 326.

272. With respect to this arrangement the Commentary provides the following guidance:

In these transactions, a consumer pledges as collateral funds that the consumer deposits in an account held by the creditor. The creditor withdraws sums from that account to supplement the consumer's periodic payments. Creditors may treat these pledged accounts as required deposits or they may treat them as consumer buy downs in accordance with the commentary to § 226.17(c)(1).

Regulation Z, 12 C.F.R. § 226.18(r)-2 cmt. 18(r)-2.

273. 704 F. Supp. at 326.

274. Regulation Z, 12 C.F.R. § 226.18(r).

275. *Id.* § 226.4(e)(1).

276. Commentary § 226.4(e)-2.

charges provision, such charges become part of the finance charge. Thus, if a creditor imposes charges on a consumer for making an assignment, they are not excludable from the finance charge even if disclosed.

The point arose in *In re Brown*²⁷⁷ when the assignee argued that filing or recording an assignment of a mortgage was similar to filing or recording the mortgage itself and that the charge should be excludable from the finance charge once it was itemized and disclosed.²⁷⁸ The court noted that the section 226.4(e)(1) exclusions all relate to charges for recording documents that affect the original transaction between the creditor and the consumer.²⁷⁹ In no way could the perfection of the mortgage itself be regarded as the same thing as perfecting an assignment of that mortgage. Furthermore, there is no exception in section 226.4(b)(6) for assignment-type charges that the consumer must pay as a result of a third party's purchase or acceptance of the consumer's obligation.²⁸⁰ Therefore, the assignee in *Brown* should have disclosed the cost of recording as a part of the finance charge.²⁸¹

The finance charge does not include disclosed fees that are or *will be paid* to public officials for perfecting, releasing or satisfying a security interest.²⁸² It is arguable that if the creditor does not use the fees for the purpose intended, the fees should be a part of the finance charge. The problem arose in *Smith v. Fidelity Consumer Discount Co.*²⁸³ when the creditor collected a thirteen dollar fee from the consumer for clearing a prior lien from the record. Unfortunately, the creditor could not obtain a release because it could not find the prior lienor. The creditor did not return the

277. 106 B.R. 852 (Bankr. E.D. Pa. 1989).

278. *Id.* at 859.

279. *Id.*

280. The Regulation includes within the finance charge these "[c]harges imposed on a creditor by another person for purchasing or accepting a consumer's obligation, if the consumer is required to pay the charges in cash, as an addition to the obligation, or as a deduction from the proceeds of the obligation." Regulation Z, 12 C.F.R. § 226.4(b)(6).

281. *Brown*, 106 B.R. at 859. In its defense, the creditor referred to *Shroder v. Suburban Coastal Corp.*, 729 F.2d 1371 (11th Cir. 1984), for the proposition that a recording fee for an assignment of mortgage was excludable from the finance charge. The *Shroder* court had relied on *George v. General Fin. Corp.*, 414 F. Supp. 33 (E.D. La. 1976), where the court held that a notary fee that was properly disclosed could be excluded from the finance charge. Unfortunately, the *Shroder* court did not make the distinction between official fees paid by the original creditor in *George* and fees paid in connection with a later assignment in *Shroder*.

282. Regulation Z, 12 C.F.R. § 226.4(e)(1).

283. 898 F.2d 896 (3d Cir. 1990).

release fee and the consumer argued that the fee was therefore a finance charge.²⁸⁴

This argument may have prevailed in the absence of a provision that forgives disclosures rendered inaccurate by subsequent events.²⁸⁵ There was no evidence that when the creditor took the release fee from the consumer, it had any inkling that it would be unable to obtain the release for filing.²⁸⁶ The subsequent event that prevented the creditor from complying with the Regulation was the creditor's inability to find the lienor to sign the release. But the Regulation does not seem to make any provision for the creditor's inability to follow through with payment for the release. As a matter of fact, the Regulation allows exclusion from the finance charge if the fees "actually are or will be paid to public officials."²⁸⁷ This suggests that the creditor must make the payment if he hopes to avoid the obligation of including the fees in the finance charge. If there is no actual payment, then the creditor should either refund the fee or include it within the finance charge if he does not intend to refund it. After all, payment to the official for releasing the lien from the public record is the event that satisfies the condition for omitting the fee from the finance charge.

If the creditor does not mention anything about a release at the time of the transaction but suddenly confronts the consumer with a demand for a release fee at the time of pay-off, the consumer may complain about the lack of disclosure. His complaint would be justified if the creditor knew at the time that the consumer would be unable to obtain credit unless the consumer agreed to pay the release charge. In that event, that would be a charge imposed as a condition of the extension of credit.

However, another issue arises if nothing is said about a release charge and the consumer is under no legal obligation to pay it. In *Adamson v. Alliance Mortgage Co.*,²⁸⁸ the creditor demanded a charge as a condition of releasing the deed of trust covering the consumer's property. The creditor did not tell the consumer about any such charge at the time of the loan and the loan documents did not obligate the consumer to pay it. The

284. *Id.* at 898-99.

285. See Regulation Z, 12 C.F.R. § 226.17(e).

286. This would be a relevant consideration if the creditor wishes to use the "subsequent event" section as a defense under section 226.17(e) of the Regulation. See NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 3.6.2 & n.401.

287. *Id.* § 226.4(e)(1) (emphasis added); see also Commentary § 226.4(e)-1 ("[o]nly sums actually paid to public officials are excludable under § 226.4-(e)(1)").

288. 861 F.2d 63 (4th Cir. 1988), *overruled on other grounds*, *Busby v. Crown Supply, Inc.*, 896 F.2d 833, 841 (4th Cir. 1990).

release charge, therefore, became an issue only after the consumer had paid off the loan. In all fairness, the charge imposed was not incident to the extension of credit, but rather incident to the satisfaction of the debt.²⁸⁹ The creditor may have left out the release charge because Truth in Lending disclosures are based on the legal obligations of the parties.²⁹⁰ If the consumer had no obligation for the charge, then the creditor should rightly not have been concerned about it. But it may simply have been an afterthought and the creditor must have believed that it had nothing to lose in reminding the consumer about this insignificant item.

The release problem is not insuperable. If the charge is going to be paid to a public official, then the Regulation allows it to be excluded from the finance charge as long as it is itemized. But the creditor should not really be overly concerned about the charge if it relates to the release of its lien. The debtor should have just as keen an interest in removing the lien from his property once he has paid his debt. Therefore, even if the creditor overlooks this matter at closing, it should not worry too much unless it is trying to collect some charge in excess of the amount due the public official. In that event, the item should properly be recognized as a finance charge and the creditor would be unable to justify the omission on the ground that it is a subsequent event. It should be able to fulfil this disclosure obligation by giving some estimate of the cost.²⁹¹

Nevertheless, this problem leads to a more fundamental question concerning the necessity for the creditor to disclose the components of the finance charge. The Regulation provides examples of the inclusions and the exclusions but nowhere requires the creditor to tell the debtor the amount of the specific items.²⁹² The creditor fulfills its duty if it merely discloses the dollar amount of the finance charge.²⁹³ Truth in Lending suggests that as long as the consumer knows the bottom line, it is not necessary to bore him with the details of the cost ingredients.²⁹⁴ But yet the creditor can

289. *Id.* at 65.

290. The Regulation requires the disclosures to reflect "the terms of the legal obligation between the parties." Regulation Z, 12 C.F.R. § 226.17(c)(1).

291. The creditor can make an estimate on the basis of the best information available and must state that the disclosure is an estimate. *Id.* § 226.17(c)(2).

292. *See id.* § 226.4(b)-(d).

293. *See id.* § 226.18(d).

294. The creditor must list any prepaid finance charge in the itemization of the amount financed. *Id.* § 226.18(c). A prepaid finance charge is "any finance charge paid separately in cash or by check before or at consummation of a transaction, or withheld from the proceeds of the credit at any time." 12 C.F.R. § 226.2(a)(23). Therefore, it is arguable that

exclude certain items from the finance charge if they are itemized.²⁹⁵ Does this mean, therefore, that they become part of that charge if they are not itemized? The consumer needs to know what he is paying and the mere disclosure of the total finance charge does not really satisfy that requirement, particularly if the creditor may be relieved from itemizing the prepaid finance charge by the consumer's inaction.²⁹⁶ The consumer should have the opportunity to reflect on the items included in the charge. The creditor may include a cost item that the consumer finds objectionable or that may even be a mistake. The consumer would not be able to discuss the matter without knowing the elements of the charge. There is a world of difference between a finance charge that includes an exorbitant finder's fee and one that merely reflects interest. The consumer may well want to weigh his options. His decision about the loan may well be affected by whether he intends to pay off the loan within a few years. The consumer can make a meaningful choice only if he has the necessary information at hand.

The creditor in *Steinbrecher v. Mid-Penn Consumer Discount Co.* (*In re Steinbrecher*)²⁹⁷ got a taste of these disclosure requirements when it included a property insurance premium in the amount financed but not in the finance charge.²⁹⁸ The court found a violation because the creditor did not provide some narrative information required for omitting the premium from the finance charge.²⁹⁹ The evil sought to be cured was really the omission of insurance information that was critical to a full understanding of the transaction.³⁰⁰ The remedy lay, therefore, not in making the premium an

the itemization of the finance charge takes place when the creditor itemizes the amount financed. However, the creditor does not have to itemize the amount financed if the creditor provides a statement about the consumer's right to receive a written itemization and the consumer does not request it. *Id.* § 226.18(c)(2). Therefore, even under these circumstances, the creditor may be relieved of the obligation if the consumer does not act.

295. See *id.* § 226.4(e) (with respect to the itemization of certain security interest charges).

296. See *Steinbrecher v. Mid-Penn Consumer Discount Co.* (*In re Steinbrecher*), 110 B.R. 155 (Bankr. E.D. Pa. 1990). The finance charge would normally include interest and the prepaid finance charge. Nevertheless, it can include other items (such as private insurance premiums) and if the creditor avoids the itemization of the prepaid finance charge through the option allowed, the consumer really will know very little about the components of the finance charge.

297. 110 B.R. 155 (Bankr. E.D. Pa. 1990).

298. *Id.* at 158.

299. *Id.* at 163. The creditor failed to inform the borrowers that the insurance could be obtained from a person of the borrowers' choice and the creditor did not disclose the term of the insurance. *Id.*

300. *Id.*

automatic ingredient of the finance charge, but rather in making the creditor liable for not providing the necessary insurance information.

The consumers in *Blon v. Bank One, Akron, N.A.*,³⁰¹ however, were on the other side of the fence. The consumers were upset because they did not know about the fee that the creditor had paid to a broker for arranging the loan although the creditor had included it in the finance charge. The creditor did not have to draw the consumers' attention to the broker's fee because Truth in Lending did not require it.³⁰² At least in this case, the characterization of the fee as a finance charge did not depend upon some omission of collateral information. The fee was a part of the finance charge and there was a simple requirement of disclosing the dollar amount.³⁰³ The lender certainly did not feel obligated to provide any details of its arrangement with the broker because it had no special relationship with the borrowers.³⁰⁴ Nevertheless, it is all too easy to overlook this gap in the disclosure requirements on the pretext that nondisclosure of the fee did not affect the borrowers' ability to compare the loan terms with others available in the marketplace.³⁰⁵ In the borrower's mind it may be a question of not only comparing terms, but also of ensuring that he is getting a fair deal.³⁰⁶

301. 519 N.E.2d 363 (1988).

302. See TILA § 128(a), 15 U.S.C. § 1638(a)(3); Regulation Z, 12 C.F.R. § 226.18(d).

303. See *Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 896 (3d Cir. 1990).

304. *Blon*, 519 N.E.2d at 367. On this point the court made this observation: "[W]e find that reasonable minds could only conclude that Bank One had no special relationship of trust and confidence with the Blons and, therefore, had no duty to disclose the details of its financing fee arrangement with West." *Id.*

305. *Id.* at 366. The court seemed satisfied that the omission of a charge of the type involved did not undermine the intent of the Truth in Lending Act to promote consumers' informed use of credit. *Id.* The question is whether the informed use of credit relates only to the opportunity to compare credit terms. The borrowers might have obtained credit elsewhere but the availability of other credit sources should not detract from the borrowers' need to know the details of the transaction in question. *Id.* at 366-67.

306. In *Blon*, the borrowers must have been fairly upset that the broker did not tell them that lower interest rates were available or that the broker would receive a higher fee on a higher interest rate. 519 N.E.2d at 367. These details could have made a difference to the borrowers. In this respect the borrowers' concern may not have been unreasonable. In *Besta v. Beneficial Loan Co.*, 855 F.2d 532 (8th Cir. 1988), the court took the view that a lender acted unfairly in not advising its customer that the customer could have obtained better loan terms by doing things differently. A similar view prevailed in *Milbourne v. Mid-Penn Consumer Discount Co. (In re Milbourne)*, 108 B.R. 522 (Bankr. E.D. Pa. 1989) when the bankruptcy court held that the lender should have told the refinancing borrower that it would be more profitable for him to take out separate loans. See also Dwight Golann, *Beyond Truth in Lending: The Duty of Affirmative Disclosure*, 46 BUS. LAW. 1307 (1991).

These examples provide some evidence of the need for properly classifying the items in the finance charge for the consumer's benefit. This approach would further the cause of disclosure by letting the consumer know the details of the transaction.

C. Insurance Coverage

Creditors are often persuaded to facilitate insurance coverage for their customers by providing information about it in the disclosure form. The Regulation seems to encourage this procedure by allowing a creditor to exclude premiums for credit life insurance from the finance charge if the creditor informs the borrower that the insurance coverage is not required and also discloses the premium for the initial period.³⁰⁷

As a matter of policy, it is questionable whether this credit insurance option belongs in a disclosure statement. The point that has been made elsewhere in connection with other items of the finance charge applies equally here.³⁰⁸ A credit insurance premium is either a finance charge or it is not and its characterization should not depend on whether the creditor informs the borrower of the voluntary nature of the insurance coverage. It is questionable whether the objective of Truth in Lending is properly fulfilled by providing for this half-hearted option in the disclosure statement.³⁰⁹ Many borrowers will like this coverage. However, they may have a genuine doubt about their options in securing it. The borrower who arrives at his loan closing to find the insurance premiums already included in the closing statement may feel a little uneasy in upsetting the lender's handiwork. Therefore, even when the insurance coverage purports to be optional because it is not a condition of the loan, the borrower may find himself locked in because of pressure.³¹⁰ But where a borrower cannot

307. Regulation Z, 12 C.F.R. § 226.4(d)(1)(i)-(ii).

308. See *supra* notes 228-29 and accompanying text.

309. The Regulation provides that the premium *may* be excluded from the finance charge. If the objective is to ensure that the borrower knows about his insurance options, then it will more likely be achieved by imposing a sanction for failure to disclose the insurance information rather than having the premium included in the finance charge. If the lender meets the requirements by such inclusion, the borrower may still not know about the insurance options. If the insurance premium provides a good return, the lender may choose to include it in the finance charge and still be competitive within the marketplace. See Golann, *supra* note 306, at 1320.

310. The Commentary provides that "[w]hether the insurance is in fact required or optional is a factual question." Commentary § 226.4(d)-5. An example of the kind of problems involved in this area is found in the Federal Trade Commission's Consent

show fraud or duress, he will have difficulty introducing evidence to counteract the disclosure statement.³¹¹ There is an implied message that the borrower is responsible for reading what he signs, a message that may be lost on the unsophisticated consumer.

Despite some early disappointments, consumers have occasionally received sympathetic consideration. In *Kaminski v. Shawmut Credit Union*,³¹² the borrowers faced clear language in a disclosure statement that credit life insurance was not required. The plaintiff showed that every borrower under seventy years of age had indeed bought such insurance and the court found it to be a requirement rather than an option for such borrowers, despite the contrary language in the instrument.³¹³ The plaintiff was unable to profit from this court's approach because he knew that he was buying insurance and would have bought it even in the absence of a requirement. Nevertheless, the court saw fit to recognize such a requirement despite the conflicting declaration in the documents that "credit life and/or disability insurance [was] not required to obtain this loan."³¹⁴ This opportunity to rebut the written word arises in the case where the lender orally misrepresents to its customers that insurance is required. However, as *Kaminski* shows, it is not easy for a consumer to make his case despite the opportunity to do so.

In *Milbourne v. Mid-Penn Consumer Discount Co. (In re Milbourne)*³¹⁵ the debtor showed that 99.5% of the lender's customers had bought credit life insurance. He did not provide any information on the number of people

Agreement with Tower Loan of Mississippi, Inc. Tower Loan was ordered to "cease and desist" from requiring any consumer to sign or initial a statement that credit-related insurance has been voluntarily chosen if the consumer's purchase of such insurance was required. See 56 Fed. Reg. 57,656, 57,657 (1991); 57 Fed. Reg. 8457 (1992).

311. The parol evidence rule prevents the introduction of evidence to contradict the written disclosures in the absence of fraud or duress. See *USLIFE Credit Corp. v. FTC*, 599 F.2d 1387 (5th Cir. 1979); *Anthony v. Community Loan & Inv. Corp.*, 559 F.2d 1363, 1369-70 (5th Cir. 1977); *Kramer v. Marine Midland Bank*, 559 F. Supp. 273 (S.D.N.Y. 1983). But see *Kaminski v. Shawmut Credit Union*, 494 F. Supp. 723, 729 (D. Mass. 1980) (fact that every borrower under seventy had purchased insurance suggested that there was an insurance purchase requirement attached to the loan); *Milbourne v. Mid-Penn Consumer Discount Co. (In re Milbourne)*, 108 B.R. 522, 542 (Bankr. E.D. Pa. 1989) (evidence of the lender's 99½% credit life insurance penetration rate was probative of the voluntariness of the borrower's insurance coverage).

312. 494 F. Supp. 723, 729 (D. Mass. 1980).

313. *Id.*

314. *Id.*

315. 108 B.R. 522 (Bankr. E.D. Pa. 1989).

who had bought credit disability insurance from the lender although he contended that the lender had required both life and disability insurance. The court noticed the absence of figures about the disability insurance and further observed that if the lender had required any insurance at all, then every borrower would have signed up for coverage through the lender.³¹⁶

Truth in Lending purports to solve the insurance problem by requiring the lender to include the premium in the finance charge if the lender does not itemize it in the disclosure statement. In effect, the legislation penalizes the non-itemizing lender by requiring the disclosure of a higher finance charge, which conceivably would put the particular lender at a competitive disadvantage. It is questionable whether the designation of the charge should change depending on the lender's conduct. If an insurance premium is not really a part of the finance charge because it does not fall within the definition thereof, then a lender's subsequent decision not to disclose the amount of that premium should not transform the item into something that it was never destined to be. The lender's transgression in the event of non-disclosure would be simply that, non-disclosure of the insurance information, and the lender then should be held accountable accordingly.

*Steinbrecher v. Mid-Penn Consumer Discount Co. (In re Steinbrecher)*³¹⁷ provided a recent example of a lender's violation. The consumers tried to rescind their transaction after declaring bankruptcy. Their successful complaint rested on the lender's underestimation of the finance charge because the lender did not make the disclosures necessary for it to exclude the fire insurance premium from the finance charge. The lender should have informed the borrowers that they could obtain the insurance from an insurer of their own choice and also should have disclosed the term of the insurance if the lender wanted to exclude the premium.³¹⁸ Even if the lender had adjusted the finance charge accordingly, the disclosure of the charge still would not have fulfilled the real purpose of the insurance provision, that is, to give the consumers the choice of

316. *Id.* at 542.

317. 110 B.R. 155 (Bankr. E.D. Pa. 1990).

318. *Id.* at 163. See also TILA § 106(c) which requires that:

Charges or premiums for insurance, written in connection with any consumer credit transaction, against loss or damage to property . . . shall be included in the finance charge unless a clear and specific statement in writing is furnished by the creditor to the person to whom the credit is extended . . . and stating that the person . . . may choose the person through which the insurance is to be obtained.

TILA § 106(c), 15 U.S.C. § 1605(c).

making their own decision. This option, not to treat the item as a part of the finance charge, ultimately allows ample opportunity to confuse consumers.

Since the statute provides some flexibility in the treatment of the insurance arrangements between the lender and the consumer, there is no compelling argument for demanding that the finance charge be involved in a resolution of this disclosure problem. The realistic solution may be to treat insurance as a separate item so that the consumer will have the chance to consider the lender's insurance offer after the terms of the loan have been settled. This arrangement would not necessarily result in a perfect solution to the insurance problem, but a separate disclosure requirement might lead to an agreement on the factors to be disclosed.³¹⁹

Another claim of exemption for an itemized insurance charge appeared recently in *Dixon v. S & S Loan Service, Inc.*³²⁰ The provision allowed the lender to exclude from the finance charge any itemized premium paid for insurance coverage to protect the lender in the event of the lender's failure to perfect his security interest.³²¹ The Act gives the lender the choice of itemizing either the recording fees actually paid to a public official or the premium payable for insurance to protect the lender from non-recording. One may ask whether the designation of the cost should change depending on the lender's itemized disclosure. With respect to this provision, the question is even more poignant because the lender is not required to exclude the item from the finance charge even if it is itemized. The Act merely prescribes that "the creditor need not include [the] item in the computation of the finance charge"³²² Very few lenders would choose to include the item because it would put the lender at a disadvantage in the marketplace. Nevertheless, the disclosure option does have the potential for creating confusion if a lender decides for any reason to make the item a part of the finance charge.

It must also be observed that the lender can exclude the recording fees from the finance charge only if such fees are actually used for the purpose intended, that is for perfecting the lender's security interest.³²³ There is no "actual payment" language in sub-section (2) dealing with the lender's

319. See Golann, *supra* note 306, at 1321-22.

320. 754 F. Supp. 1567 (S.D. Ga. 1990).

321. *Id.* at 1572; see also TILA § 106(d), 15 U.S.C. § 1605(d).

322. TILA § 106(d), 15 U.S.C. § 1605(d).

323. The creditor does not have to include "[f]ees and charges . . . which actually are or will be paid to public officials." *Id.* § 106(d)(1), 15 U.S.C. § 1605(d)(1).

option of itemizing the premium payable for insurance.³²⁴ Nevertheless, the Official Commentary makes the point that if the lender keeps the premium as a kind of "self-insurance against non-filing," then it must include the premium in the finance charge.³²⁵ The premium cannot be excluded if the lender does not actually purchase the non-filing insurance. The Commentary's explanation would not have been necessary if sub-section (2), like sub-section (1), required the charge to be "actually" paid. Instead, the sub-section only requires that the premium be "payable for . . . insurance in lieu of perfecting any security interest." This phrase required the Commentary to confirm that the lender must actually purchase the insurance. It would have been much better if the actual payment requirement had been specifically included.

Some of the problems which have arisen in connection with these insurance provisions raise questions about the underlying purpose of the Act. Strictly speaking, the ultimate objective is "to assure a meaningful disclosure of credit terms."³²⁶ One wonders whether the disclosure of this information contributes to this objective. The ultimate solution is to allow borrowers to make their own insurance arrangements. Arguably, however, lenders would want every opportunity to provide such service.

In *Sutton v. First National Bank*³²⁷ the lender knew why it wanted to arrange the borrowers' credit insurance; it received forty percent of the premiums.³²⁸ The only difficulty was that the bank had apparently forgotten to apply for the insurance coverage. The lender later tried to take advantage of the ambiguous form, for the borrower had signed in a place indicating that he wanted insurance while the date appeared in a place designated for those who did not want insurance.³²⁹ The court viewed the section on credit insurance as "totally irrelevant to [the] loan unless it was intended . . . as an offer to procure credit insurance."³³⁰ It was, therefore,

324. Sub-section (2) refers to "[t]he premium payable for any insurance." *Id.* § 106(d)(2), 15 U.S.C. § 1605(d)(2).

325. Commentary § 226.4(e)-4.

326. TILA § 102(a), 15 U.S.C. § 1601(a).

327. 620 S.W.2d 526 (Tenn. Ct. App. 1981).

328. *Id.* at 530.

329. *Id.* at 527.

330. *Id.* at 530; see also *Stone v. Davis*, 419 N.E.2d 1094 (Ohio), *cert. denied*, 454 U.S. 1081 (1981) (banks using Regulation Z disclosure forms to ascertain a borrower's desire for insurance and negligently failing to tell the borrower to get the disclosure form himself, breaches its duty of disclosure); *Hancock Bank v. Travis*, 580 So. 2d 727 (Miss. 1991) (bank liable for failure to procure credit and liability insurance).

the bank's contractual duty to obtain the insurance for the borrower.

Similarly, in *Heinert v. Home Federal Savings & Loan Ass'n*,³³¹ the lender tried to make an issue of the ambiguity in the disclosure statement hoping to show that it was merely complying with the Act. The ambiguity concerned a peculiar sentence on the insurance coverage line: "I desire *assume other for now* insurance coverage."³³² One meaning of the phrase "assume other for now" could be that the borrower was willing to take over someone's insurance policy rather than taking any of the insurance listed in the disclosure statement. However, the statement indicated that no insurance would be provided unless the borrower signed in the appropriate place.³³³ The borrower did sign, thus providing some conflict between the borrower's signature and the "assume other for now" clause.

It was not unreasonable for the court to construe this ambiguity against the bank. Since the bank had drafted the form, it was understandable that the court would accept it as the bank's offer to procure insurance. The bank fell into its predicament only because the Act allows a disclosure statement to include not only true credit terms, but also language about the availability of insurance through the lender. It is not surprising, therefore, that lenders grasp the opportunity to advertise this feature. Nevertheless, it is just one more reason for examining the real functions of the insurance provisions within the disclosure framework.

V. CONSUMER OPTIONS

A. Damages

In an appropriate case, a consumer may recover both actual damages and statutory damages for a Truth in Lending violation. The consumer may recover actual damages for a creditor's breach of any disclosure requirements but only statutory damages for failing to provide certain material disclosures.³³⁴

In closed-end transactions, a creditor who "fails to comply with any requirement . . . with respect to any person is liable to such person."³³⁵

331. 444 N.W.2d 718 (S.D. 1989).

332. *Id.* at 719.

333. *Id.*

334. TILA § 130, 15 U.S.C. § 1640.

335. *Id.*

In closed-end transactions, a creditor who "fails to comply with any requirement . . . with respect to any person is liable to such person."³³⁵ Therefore, the person to whom the duty is owed is the one who has the cause of action. For example, in a non-rescindable transaction, a surety has no claim for damages if the creditor provides the principal with inaccurate disclosures, although it is possible that a surety will rely on disclosures given to the primary obligor in determining whether he should undertake his obligation.³³⁶

In this respect, the surety is very much like a joint obligor in a transaction who may not receive any disclosures because Regulation Z does not require the creditor to give disclosures to more than one consumer.³³⁷ Nevertheless, if the creditor gives erroneous disclosures to one obligor, the joint obligor who did not receive any disclosures still has a remedy.³³⁸ In essence his complaint would be based on the creditor's failure to perform a clear, statutory obligation. Likewise, a surety does not have the right to demand disclosures from the creditor, but in good conscience may expect his principal to have access to proper and true information.³³⁹

A surety may have such expectations because of the statutory language that a creditor may have liability to "any person."³⁴⁰ It is a curious deviation from the term "consumer" because it suggests that a broader group of beneficiaries was intended.³⁴¹ Had the statute mentioned only "consum-

335. *Id.*

336. Commentary § 226.2(a)(11)-1; *Aurora Firefighter's Credit Union v. Harvey*, 516 N.E.2d 1028 (Ill. App. Ct. 1987).

337. If there is more than one consumer, the creditor may make disclosures to any consumer who is primarily liable. However, in a rescindable transaction, the creditor must make disclosures to each consumer who has a right to rescind. Regulation Z, 12 C.F.R. § 226.5(d).

338. Creditors are responsible for only one recovery of statutory damages but actual damages can be recovered by "any person" who suffers them. TILA § 130(d), 15 U.S.C. § 1640(d).

339. In the same way that the creditor expects the co-obligor to see a copy of the disclosures which he has given to the primary obligor, so too the creditor should not be surprised if the co-obligor obtains a copy of the disclosure statement. To that extent the co-obligor is a "person" for whom the creditor's attempt at compliance has failed. See TILA § 130(a), 15 U.S.C. § 1640(a); *Barash v. Gale Employees Credit Union*, 659 F.2d 765, 767 (7th Cir. 1981). The creditor has a duty not to provide faulty disclosures to multiple borrowers even though only one of them is actually entitled to the statement. See also NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 2.2.1.2.

340. See TILA § 130(a), 15 U.S.C. § 1640(a).

341. See NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 2.2.1.2. Prior to an amendment in 1985 an action under the Equal Credit Opportunity Act seemed to be restricted

ers," the problem of identifying possible plaintiffs would not arise. However, by using different language, the draftsmen may have been sending a message that consumers were not the only proper complainants. It is reasonably clear that a secondary party does not have any right to disclosures. Nevertheless, it may be logical to expect that such a person may rely on the disclosures which the primary obligor obtains from the creditor. If that reliance is sufficient to place an obligation on the creditor towards a secondary party, then that party has a right to complain if the creditor does not comply with the requirements. It is simply a question of determining whether a creditor's liability must be limited to the person to whom disclosures are made. In the case of joint obligors, the liability is not so limited because either obligor has a claim to disclosures, and the disclosure to one satisfies the disclosure obligation with respect to the other. In the case of a secondary party, there is no right to disclosures and even if the creditor gratuitously provides them, he is still not relieved of the obligation to take care of the primary obligor.³⁴² Therefore, any claim the surety has must be based not on his own statutory right to disclosures, but rather on his expectation that the creditor will make proper disclosures to the primary party. That would account for the use in the liability section of the term "any person" rather than "consumer."

Sometimes the question of damages arises from an unusual transaction. In *Hemauer v. ITT Financial Services*,³⁴³ the consumers were interested in a loan for \$10,000. Surprisingly, the creditor did not structure the transaction as a single loan but rather as two loans dated on successive days. The first loan was an unsecured loan at an annual percentage rate of 34.6% and the second loan was secured by the consumers' home at an annual percentage rate of eighteen percent. The creditor gave the consumers a disclosure statement for each loan and satisfied the first loan with the proceeds of the second.³⁴⁴

The structure of the transaction was deficient in many respects. The

202.2(e) (1992). Under Regulation Z, disclosures must be made to "consumers." Regulation Z, 12 C.F.R. §§ 226.5(a), 226.17(a). However, a creditor who fails to comply with its obligation to any "person" is liable to such "person." TILA 130(d), 15 U.S.C. § 1640(d).

342. The underlying theory of this obligation is to ensure that the creditor does not bypass the primary party in making the disclosures. See NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 2.2.1.2 n.12. The Commentary also confirms that a creditor's disclosure obligations are not met by making disclosures to a surety only. Commentary § 226.5(d)-2.

343. 751 F. Supp. 1241 (W.D. Ky. 1990).

344. *Id.* at 1242-43.

consumers had expressed an interest in a loan for \$10,000 and ended up signing papers on December 10th for two loans, one of which had documents dated December 10th and the other December 11th. The court held that the creditor had not made clear disclosures as required.³⁴⁵ This was hardly surprising because this was really one loan and the creditor obviously had some reason for transforming this single loan into two loans. The consumers had an idea that the creditor structured the transaction in such a way as to discourage the consumers from rescinding.³⁴⁶ If the creditor had given only one secured loan, the consumers would have had the right to rescind and that would have been the end of the arrangement. However, as there were separate disbursements, the consumers' rescission of the second loan would have reinstated the prior unsecured loan. It was a theory worthy of support; at least it was a plausible explanation of the creditor's strategy.

Having recognized the problem, the court had to respond to the consumers' claim for damages. It was a dilemma that was quite unanticipated. Arguably, if the creditor should have treated the transaction as one loan, the consumers would be entitled to damages for one violation only. That was not to be the case. The court felt comfortable in awarding damages for each loan because the creditor itself had recognized two transactions.³⁴⁷

Apparently the creditor had not faltered in making the disclosures for each loan and the only basis for its liability was in treating the transaction as one loan. But the court wanted it both ways and so decided on damages for each loan, in effect, inflicting double liability for a single transaction. It was a fiction that went too far, for the arrangement could hardly be categorized as one loan for one purpose and two loans for another purpose.³⁴⁸

But the court's generosity did not end there. The court awarded damages to each consumer involved in the transaction.³⁴⁹ This award must have surprised even the consumers, for as multiple obligors they were

345. *Id.* at 1244.

346. *Id.* Only the December 11th loan was rescindable because it was secured by the consumers' principal dwelling. Therefore, even if the consumers had rescinded, they would still have had to face the December 10th loan.

347. *Id.* at 1245.

348. *See Lender That Split One Loan into Two Gets Some Grief, but More Than It Should*, CONSUMER CREDIT & TRUTH-IN-LENDING COMPLIANCE REP., Apr. 1991, at 3.

349. *Hemauer*, 751 F. Supp. at 1245.

surely not entitled to more than one recovery.³⁵⁰ This double recovery problem was solved when Congress simplified the Truth in Lending Act in 1980.³⁵¹ It was a step in the right direction for many a violator found himself in a difficult position, depending on the number of consumers in a particular transaction.³⁵² When the Act was eventually amended, it provided welcome relief for creditors, who then had a better idea of their exposure to liability.

Nevertheless, creditors may still be subject to double exposure in a sense because some states allow consumers to recover under state law for a breach of their Truth in Lending laws.³⁵³ The federal Act does not prohibit recovery under state laws and the court in *Hemauer* was on sound ground in allowing additional recovery under state law, although the recovery should have been limited to one consumer.

The creditor exhibited a peculiar strategy in *Hemauer*. The consumers recovered for the creditor's deficiency, albeit too generously according to the statutory scheme. There are some occasions when the consumer may get nothing despite the irregularity of the creditor's conduct. It is a reminder that Truth in Lending was not designed to take care of all ills in consumer transactions.

The latest example came in *Jensen v. Ray Kim Ford, Inc.*³⁵⁴ The parties settled on an installment contract that estimated the value of a trade-in automobile as \$800. They agreed that they would make any necessary adjustments later if the estimate was inaccurate.³⁵⁵ As it turned out, the

350. TILA § 130(d), 15 U.S.C. § 1640(d). The court relied on *Berryhill v. Rich Plan*, 578 F.2d 1092 (5th Cir. 1978), which was decided before the Truth in Lending Simplification and Reform Act was passed. See *Hemauer*, 751 F. Supp. at 1244-45.

351. Truth in Lending Simplification and Reform Act, Pub. L. No. 96-221, § 615(d), 94 Stat. 168, 181 (1980). The new version emphasized the violation aspect rather than the ability of each and every obligor to recover. See *Brown v. Marquette Sav. & Loan Ass'n*, 686 F.2d 608, 615 (7th Cir. 1982).

352. See *Barash v. Gale Employees Credit Union*, 659 F.2d 765 (7th Cir. 1981); *Anderson v. Farmers Bank*, 640 F.2d 1347 (8th Cir. 1981); *Berryhill v. Rich Plan*, 578 F.2d 1092 (5th Cir. 1978); *ROHNER*, *supra* note 251, ¶ 12.04[2][b].

353. Some state statutes require a consumer to make an election of remedies. See, e.g., S.C. CODE ANN. § 37-5-203(7) (Law. Co-op. 1976); TEX. REV. CIV. STAT. ANN. art. 5069-8.01(h) (West 1987). If state law is silent on this issue, the consumer can usually recover under both Truth in Lending and the state statute. See *Cantrell v. First Nat'l Bank*, 560 S.W.2d 721, 730 (Tex. Civ. App. 1977); *Public Fin. Corp. v. Riddle*, 403 N.E.2d 1316, 1320 (Ill. App. Ct. 1980); NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 8.4.4.

354. 920 F.2d 3 (7th Cir. 1990).

355. *Id.*

trade-in was worth more and the creditor knew that it had to refund some money to the consumers.³⁵⁶ Instead of doing so, the creditor allegedly forged the consumers' signatures to a second installment contract which took account of the full value of the trade-in but made other changes that reflected an increase in other charges.³⁵⁷ When the consumers found out about this second contract, they sought Truth in Lending damages for the creditor's failure to give them disclosures covering that contract.

The creditor's conduct was inappropriate and resulted in a forged contract that did not bind the consumers. A creditor must provide disclosures to anyone who is *obligated* on a consumer credit transaction.³⁵⁸ Here, the consummation had already taken place when the creditor decided on its own to substitute new documents for the old, without the consumers' consent.³⁵⁹ The substitution of the forged document was simply a device to mask the new figures so that the trade-in figure could properly be absorbed in the disclosure statement without drawing the consumers' attention to the event. The creditor did not intend to share its strategy with the consumers and so there was no plan in sight for the new transaction to be consummated. The *Jensen* court took the view that there was no consummation of the second installment contract, and therefore, no obligation of discharge.³⁶⁰ The second installment contract was void and the consumers could do nothing to rescue it, even for the purpose of imposing Truth in Lending liability on the creditor.³⁶¹

Nevertheless, the consumers tried to justify their claim for damages. They thought it best to do so by ratifying the forged document in order to impose a disclosure obligation on the creditor. However, disclosure was required before consummation of the transaction and that occurred when the parties signed the original documents. The creditor could not have expected a forged document to bind the consumers and therefore it really did not expect any obligation to ensue from the subsequent documentation. After all, the purpose for a disclosure statement is to allow consumers to compare the available financing options and there would be no point in allowing

356. *Id.*

357. *Id.* at 4.

358. TILA § 121(a), 15 U.S.C. § 1631(a). Generally, that obligation arises only when the transaction is consummated and the creditor has a duty to disclose before consummation of the transaction. Regulation Z, 12 C.F.R. § 226.17(b).

359. Consummation "means the time that a consumer becomes contractually obligated on a credit transaction." Regulation Z, 12 C.F.R. § 226.2(a)(13).

360. 920 F.2d at 4.

361. *Id.*

damages in a *Jensen*-type case, just because a consumer might wish to avenge a creditor's forgery.³⁶² If the creditor never intended the consumers to be bound, there was no chance of the transaction being consummated. There was no need for the consumers to review the second option because there was no intention for them to be obligated on the forged documents. The creditor was not interested in bringing the documents to the consumers' attention and the consumers did not know about them. It was not possible, therefore, for the creditor to make its disclosures before consummation because the creditor was not negotiating with the consumers about a new transaction and did not expect any agreement to materialize.

If the rationale for a disclosure statement is to be maintained, then disclosure should precede consummation of the arrangement between the parties. A subsequent void event should not be allowed to upset the original contract between them solely to chastise the creditor. The remedy for such conduct lies elsewhere and not in Truth in Lending.³⁶³

If a creditor does not take the necessary action to implement a consumer's rescission, it will be liable for damages.³⁶⁴ A creditor's inaction may be evidenced by the creditor's failure to return a consumer's commitment fee or to terminate the security interest on the consumer's property.³⁶⁵ However, in *Manor Mortgage Corp. v. Giuliano*,³⁶⁶ the consumer rescinded the transaction and the lender nevertheless sued for the commitment fee. The lender did not question the consumer's right to rescind but believed itself entitled to the commitment fee, perhaps on the

362. See *id.*; see also *Consumers May Not Ratify Forged Documents to Obtain Truth-in-Lending Damages*, CONSUMER CREDIT & TRUTH-IN-LENDING COMPLIANCE REP., Apr. 1991, at 5 [hereinafter *Truth-in-Lending Damages*].

363. The court said, "[r]eprehensible as it would be for a lender to concoct and forge a more onerous substitute and sell it to a credit company in the hope that the consumer would fail to notice the difference, we do not find that the Act prohibits or provides a civil remedy for such conduct." *Jensen*, 920 F.2d at 4. The consumers favored an interpretation of the Truth in Lending statute that would have required the creditor to make disclosures obligated by either the original contract or a later forged contract that was ratified by them. See *Truth-in-Lending Damages*, *supra* note 362, at 5.

364. In an individual action a creditor will be liable for any actual damage and twice the amount of any finance charge. However, the liability cannot be less than \$100 nor greater than \$1,000. A consumer can also recover a reasonable attorney's fee and costs in any successful action to enforce a lender's liability or in any action in which a court determines that the consumer has a right of rescission. TILA § 130(a), 15 U.S.C. § 1640(a).

365. A creditor must take the necessary action within twenty days to return the obligor's property and to terminate the security interest. TILA § 125(b), 15 U.S.C. § 1635(b); Regulation Z, 12 C.F.R. § 226.23(d)(2).

366. 596 A.2d 763 (N.J. Super. Ct. App. Div. 1991).

theory that rescission of the transaction did not affect the consumer's obligation to pay for the lender's commitment.

It is noteworthy that the creditor had not failed to return the consumer's property, for the consumer had paid the lender nothing. Nevertheless, the court saw no distinction between a lender's wrongful retention of a consumer's money and a lender's wrongful attempt to collect a commitment fee, which the lender would have had to return in any event if the consumer had paid it.³⁶⁷ Both acts violated the rescission provision and the court allowed \$1,000 damages plus costs and attorney's fees.³⁶⁸

This view leads to another query about how the lender committed the violation. The statute does not literally demand the creditor to refrain from suing the consumer for a fee or other charge which is not due; however, it does provide that a consumer is not liable for any "finance or other charge" when he rescinds a transaction.³⁶⁹ Therefore, a consumer's rescission should also discharge the consumer from any promise to pay any such charge and the lender's attempt to recover it puts the lender in violation because of the failure to recognize the termination of the consumer's liability.³⁷⁰ The New Jersey Superior Court put it best when it said that "[t]o distinguish a wrongful withholding of improperly retained charges from a wrongful attempt to collect such barred charges would be to elevate form over substance."³⁷¹ The lender cannot acknowledge the consumer's right to rescind on the one hand and then seek to ignore it on the other by asserting an unfounded claim for a charge not due. The substance of the matter is that the consumer owes nothing and the creditor should not be able to frustrate the rescission procedure by putting the consumer in this bind.

B. Recoupment

Truth in Lending requires a consumer to bring an action for damages within one year after a breach.³⁷² Nevertheless, if a lender brings an action against the consumer, the consumer may recoup his Truth in Lending

367. *Id.* at 766.

368. *Id.* The court levied the maximum penalty of \$1,000 and took the view that such a penalty was intended to deter not only "cgregious conduct" but "all violations of the Act." *Id.*

369. TILA § 125(b), 15 U.S.C. § 1635(b).

370. See *Don't Sue for Commitment Fee After Rescission*, CONSUMER CREDIT & TRUTH-IN-LENDING COMPLIANCE REP., Feb. 1992, at 3.

371. *Manor Mortgage Corp.*, 596 A.2d at 766.

372. TILA § 130(e), 15 U.S.C. § 1640(e).

damages as long as state law does not prevent recoupment of stale claims.³⁷³ Some recent decisions which have dealt with this recoupment remedy have reached different conclusions on its availability, perhaps based in part on a misunderstanding of applicable state law.

The difficulty was accentuated in *New York Guardian Mortgage Corp. v. Dietzel*,³⁷⁴ when the court would not allow a consumer to assert a Truth in Lending counterclaim in a mortgage foreclosure action. The *Dietzel* court took the view that a consumer's recoupment was available only in a lender's action for money damages against the consumer rather than in a foreclosure action where the primary mission was to sell the collateral and satisfy the debt.³⁷⁵ Although section 130(e) allows recoupment in "an action . . . to collect the debt,"³⁷⁶ the *Dietzel* court would not characterize a foreclosure action as an action to collect a debt because it was an *in rem* proceeding.³⁷⁷ Its failure to do so ignored the real purpose of the statute. After all, the purpose of a foreclosure action is to allow the lender to realize on its security and it should not matter whether the lender does so through a personal judgment against the consumer or through a sale of the collateral.

It took a case like *Dangler v. Central Mortgage Co.*³⁷⁸ to point out the error of the *Dietzel* court. The *Dangler* court recalled that *Dietzel* had classified a foreclosure as an *in rem* proceeding, the purpose of which was only to sell the mortgaged property. The *Dangler* court saw this as "a brief lapse in reasoning"³⁷⁹ and could not be persuaded to follow *Dietzel*. In any event, the *Dangler* situation was a little different. It was not recoupment in a foreclosure action but rather in a proof of claim filed by the mortgagor in the mortgagor's bankruptcy proceeding. Therefore, even if the *Dangler* court had any doubts about the *Dietzel* categorization of a foreclosure action, it had no difficulty in identifying the proof of claim transaction as an attempt to collect a debt.³⁸⁰ Thus, recoupment was

373. *Id.*

374. 524 A.2d 951 (Pa. Super. Ct. 1987).

375. The court explained that "[a] judgment in a mortgage foreclosure action is not a judgment for money damages and therefore cannot be 'an action to collect amounts owed' or 'an action to collect the debt' as required under § 1640(h) and (e) of the Truth in Lending Act." *Id.* at 953.

376. TILA § 130(e), 15 U.S.C. § 1640(e).

377. 524 A.2d at 952.

378. 75 B.R. 931 (Bankr. E.D. Pa. 1987).

379. *Id.* at 936.

380. The *Dangler* court stated that "irrespective of what might be true as a mortgage foreclosure action, the filing of a Proof of Claim clearly is an attempt 'to collect amounts owed.'" *Id.* at 937 (emphasis added); see *Werts v. Federal Nat'l*

clearly in order.

The debtor in *Dangler* pressed his recoupment claim by initiating an adversary proceeding in bankruptcy, thus reducing the lender's claim by the Truth in Lending damages. If it seemed that the debtor was asserting an affirmative claim here, that would be no surprise. This was the way that the debtor could resist the lender's proof of claim in bankruptcy. In this way the debtor hoped to reduce the lender's recovery.

A debtor should not necessarily be successful simply by initiating an adversary proceeding. Unless there is a proof of claim in the bankruptcy proceeding, the debtor does not really have a basis for recoupment. Therefore, if the lender does not file a proof of claim, the debtor may have to do so in order to treat his Truth in Lending claim as recoupment. In *Jones v. Progressive-Home Federal Savings & Loan Ass'n (In re Jones)*,³⁸¹ the debtor really wanted a judgment for Truth in Lending damages from the bankruptcy court although the lender had not filed a proof of claim. Having already secured a judgment of foreclosure in state court, the lender made a motion in the bankruptcy proceeding to remove the automatic stay which had affected its foreclosure proceeding as a result of the bankruptcy filing.³⁸² It was obviously content to rely on the foreclosure proceeding in the state court and wanted it to proceed. Therefore, it had no interest in filing a proof of claim in bankruptcy. However, the debtor would not be outdone. He not only filed a proof of claim for the lender, but he also brought an adversary proceeding against the lender in opposition to the lender's claim and later included a claim for a Truth in Lending violation.³⁸³ It was the consumer's way of making his case for Truth-in-Lending damages. The only problem was that the one-year statute of limitations had long passed and the consumer could succeed only if he made his Truth in Lending claim through recoupment and thus was in a defensive posture.

The court in *Jones* made the point that filing a proof of claim was very much like bringing a collection action and that similarity did not disappear simply because the consumer was the one who had filed the proof of claim for the lender.³⁸⁴ The basis of the consumer's objection to the lender's

Mortgage Ass'n, 48 B.R. 980 (Bankr. E.D. Pa. 1985).

381. 122 B.R. 246 (Bankr. W.D. Pa. 1990).

382. *Id.* at 248.

383. *Id.*

384. *Id.* at 250. The Bankruptcy Code allows a debtor to file a proof of claim on the creditor's behalf if the creditor does not file. 11 U.S.C. § 501(c) (1988).

claim was the Truth in Lending violation and the consumer had hoped to reduce that claim by the damages to which he was entitled. This was recoupment rather than set-off because both the consumer's claim and the lender's claim were grounded in the same transaction. However, section 130(e) of the Truth in Lending Act allows a consumer to assert a Truth in Lending claim beyond the one-year limitation through recoupment or set-off, unless state law provides otherwise.

In the ordinary collection action, one should look to state law to ascertain whether a Truth in Lending defensive claim is regarded as one based on recoupment or set-off.³⁸⁵ Section 130(e) suggests the same approach for a Truth in Lending claim asserted defensively in bankruptcy proceedings. If a consumer's claim is made in response to a creditor's proof of claim, then it is protected by the statute and can only be countered by state law. Curiously enough, the court in *Jones* did not seem too bothered by the language "except as otherwise provided by state law." It seemed to be satisfied with a resolution based on federal law and treated the old Truth in Lending claim as one involving recoupment without any consideration of the state law implications of section 130(e). The exclusion of the state law aspects left some questions unanswered about the role of that statutory exception.

C. Attorney's Fees

The Truth in Lending Act requires a creditor to pay costs and attorney's fees for the consumer in any successful action brought by the consumer to recover damages or to enforce the right of rescission.³⁸⁶ This provision is helpful in encouraging a consumer to seek his statutory remedy. On the other hand, it is arguable that some consumers take advantage of this mechanism to lodge questionable claims. That is the obvious sacrifice produced by a provision of this sort. It is understandable that Congress wanted to facilitate the enforcement of the Act by allowing a consumer to recover attorney's fees in a successful action. Many consumers are unable to afford the cost of a lawsuit and it was the congressional will to create

385. See ROHNER, *supra* note 251, § 12.05[4][6], at 12-58. In *Vikowsky v. Savannah Appliance Serv. Corp.*, 345 S.E.2d 621 (Ga. Ct. App. 1986), the court accepted the state law characterization of a Truth in Lending claim as a setoff and held it to be time barred under state law. On the other hand, in *First State Bank v. Phillips*, 681 S.W.2d 408 (Ark. Ct. App. 1984), the court viewed the Truth in Lending claim as one in recoupment without reference to state law.

386. TILA § 130(a)(3), 15 U.S.C. § 1640(a)(3).

rights in consumers as private attorneys-general. It would be pointless for consumers to have these statutory rights if they were nevertheless unable to enforce them because of a lack of resources.

Nevertheless, it is difficult sometimes for a court to decide when a consumer's action has been successful. For example, in *Jones v. Mid-Penn Consumer Discount Co.*³⁸⁷ a consumer obtained a loan and then refinanced it with another loan. The consumer brought an action in the bankruptcy court to enforce rescission of the two loans. The court took the view that the consumer could rescind the second loan but not the first. However, the court did not award any attorney's fees for the time that the attorney spent on rescission of the first loan. The court took a rather strict view of the statutory language in restricting recovery to the second loan but one that might be defended on the ground that the first loan was no longer in existence when the consumer sought rescission. The consumer had already refinanced it with the second loan.³⁸⁸

When the consumer offers two bases for the rescission of a loan and only one is sustained, the consumer should still be able to get attorney's fees for the work done to justify both grounds.³⁸⁹ If courts did not allow such a recovery, it would have a chilling effect on an attorney's bona fide efforts to present alternative arguments in support of his client's position. The situation should be different if the attorney submits a whole list of unreasonable arguments in the hope that one will succeed. Even if one ground prevails under this scenario, the consumer would have a weaker argument in trying to recover for work done on the unsuccessful claims.³⁹⁰ A consumer should act in good faith in asserting alternative grounds for rescission. This is but a small price to pay for the right to recover attorney's fees.

Sometimes there is no trial because the parties agree on a settlement. Bearing in mind that a reasonable attorney's fee can be awarded only in a successful action, one might ask whether a court can nevertheless make an award even if there is no trial. If the court enters judgment based on a

387. 93 B.R. 66 (Bankr. E.D. Pa. 1988).

388. *Id.* at 67.

389. *Id.*

390. See *Kramer v. Marine Midland Bank*, 577 F. Supp. 999, 1000 (S.D.N.Y. 1984) (attorney's fee denied for unrelated, unsuccessful claims (citing *Hensley v. Eckerhart*, 461 U.S. 424, 434 (1983))). If a consumer's action is frivolous, the defendant may recover double costs and reasonable attorney's fees. *Rush v. Macy's N.Y., Inc.*, 775 F.2d 1554 (11th Cir. 1985).

stipulation of settlement, the consumer should be entitled to attorney's fees.³⁹¹ This recovery would be based on the agreement for damages in the stipulation of settlement, for there would be no doubt that the consumer's action was successful in statutory terms. The consumer is not required to carry his claim through to trial if the creditor is willing to admit his liability and avoid a trial. This would be advantageous to both parties; the consumer prevails on his right to rescind and the creditor avoids large attorney's fees.

Difficulties arise, however, when the parties agree on a settlement but fail to make provision for attorney's fees. The failure to deal with this issue can be interpreted as a waiver.³⁹² It is preferable, therefore, for the parties to provide explicitly for attorney's fees, either by settlement in the agreement itself or by leaving it for further negotiation. If an attorney waives his fees, it must be a true waiver.³⁹³ Therefore, an attorney cannot waive his fees in a settlement agreement, and then try to recover them later on the ground that the waiver bound the client and not the attorney.³⁹⁴ Since the right to attorney's fees resides in the consumer, the consumer is the only one who can bring an action for them. Therefore, it is left to the consumer to invalidate the entire settlement if he wants to reverse himself and obtain attorney's fees.

The consumer's action should also be regarded as successful if the consumer obtains a default judgment.³⁹⁵ Although there may be some

391. *Gram v. Bank of La.*, 691 F.2d 728 (5th Cir. 1982); see also *Freeman v. B & B Assoc.*, 595 F. Supp. 1338 (D.D.C. 1984), *rev'd on other grounds*, 790 F.2d 145 (D.C. Cir. 1986); *In re Szostek*, 93 B.R. 399, 407 (Bankr. E.D. Pa. 1988) (stating that even if the creditor does not admit a Truth in Lending violation and agrees to settle because of other claims of the consumer, an attorney's fee should still be awarded); *Poussard v. Commercial Credit Plan, Inc.*, 479 A.2d 881 (Me. 1984); NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 8.6.2.4.1, at 317.

392. *Young v. Powell*, 729 F.2d 563 (8th Cir. 1984); *Jennings v. Metropolitan Gov't*, 715 F.2d 1111 (6th Cir. 1983). *Contra Muckleshoot Tribe v. Puget Sound Power & Light Co.*, 875 F.2d 695 (9th Cir. 1989).

393. In *Evans v. Jeff D.*, 475 U.S. 717 (1986), the Supreme Court looked with disfavor upon an attorney's waiver of fees subject to a court's approval of the settlement. The attorney had hoped that the court would approve the settlement but then also make provision for an attorney's fee. The Supreme Court held that the trial court would have to accept or reject the settlement in toto. *Id.*

394. *Freeman v. B & B Assoc.*, 790 F.2d 145 (D.C. Cir. 1986) (attorney unsuccessful in bringing an independent action for his fee which claimed that the settlement waiver bound the client only).

395. See NATIONAL CONSUMER LAW CENTER, *supra* note 129, § 8.6.2.1, at 316 (citing *City Finance Co. v. Boykin*, 358 S.E.2d 83 (N.C. Ct. App. 1987)); *Rodriguez v. Holmstrom*,

question about the reason for the default judgment, the consumer should not be prejudiced by the creditor's failure to respond. One might characterize this as success by default, but the rationale for an attorney's fee is consistent with an award in the face of the creditor's silence. Otherwise, the creditor could undermine the scheme by ignoring the consumer's claim, even if the consumer is on solid ground.

Although a creditor will usually pay attorney's fees to the consumer and not to the attorney directly, it is proper for a court to acknowledge an attorney's independent right to fees if the creditor is trying to offset his counterclaim against the attorney's fees. In that case, a court would find it consistent with the objectives of Truth in Lending to pay the fees directly to the attorney.³⁹⁶ The same approach is justified if a bankrupt consumer recovers on a Truth in Lending claim. The fees would properly be paid to the attorney. If not, the consumer's creditors would lay claim to them as part of the bankruptcy estate and the attorney would find himself deprived of his fees.

An attorney should also not lose his fees simply because his consumer-client has obtained a generous award for damages. In *De Jesus v. Banco Popular de Puerto Rico*,³⁹⁷ the creditor must have thought that the consumer was amply rewarded with a recovery of \$30,000 and that the consumer's recovery for attorney's fees would be taking things too far. It was an argument destined to failure, for the court ruled that the consumer was statutorily entitled to attorney's fees once he had succeeded with his lawsuit.³⁹⁸ There was no basis on which the court could deny recovery for such fees simply because the jury had given the consumer a handsome sum for the creditor's violation. Otherwise, the attorney's fees would depend upon the size of the award of damages to the consumer.

Leaving nothing to chance, the creditor tried to persuade the court that the consumer was not really successful in his lawsuit because the jury had awarded him less than he had sought at settlement.³⁹⁹ This was a new criterion for success that the court would not accept. In any event, the argument highlighted the inconsistency of the creditor's position, because it alleged on one hand that the consumer had received more damages than he

627 S.W.2d 198 (Tex. Ct. App. 1981).

396. See *Plant v. Blazer Fin. Servs. Inc.*, 598 F.2d 1357, 1365-66 (5th Cir. 1979); *In re DiCianno*, 58 B.R. 810, 814 (Bankr. E.D. Pa. 1986).

397. 918 F.2d 232 (1st Cir. 1990).

398. *Id.* at 235.

399. *Id.* at 234.

was entitled to, while on the other hand it trumpeted the consumer's recovery as a lack of success. The creditor's argument did not succeed in light of the statutory entitlement to attorney's fees.⁴⁰⁰

If a consumer asserts a Truth in Lending claim as a defense to a creditor's suit, a successful consumer can recover attorney's fees. Moreover, such fees are allowable even if they turn out to be more than the consumer's recovery.⁴⁰¹ The courts attempt to ensure that the attorney is not deprived of his fees by a technical application of the statute. Therefore, although the statute of limitations can prevent an action to enforce a Truth in Lending action, it cannot prevent a consumer's recoupment defense. An attorney would be entitled to reasonable fees in that event, for otherwise the consumer would be denied a real opportunity to present his defense.

VI. CONCLUSION

The Truth in Lending Act has proven to be successful in clarifying the terms of consumer credit. Consumers have profited from the informed use of credit. The consumer's ability to compare the cost of credit has led to a healthy competition in the marketplace. Nevertheless, there is always room for improvement in the scheme of things and even more success is possible if Truth in Lending disclosures can be tailored to provide just enough information without overkill.

While it may be helpful to inform a consumer about every conceivable charge involved in a transaction, there is a point of diminishing returns. It is, therefore, a challenge for the regulators to keep the disclosure requirements within reasonable bounds so that consumers will be able to make effective use of the information provided. In this respect, it is confusing for the Regulation to exclude an item from the finance charge simply because the lender chooses to itemize it. The lender's failure to itemize should not

400. The court referred to the language of a civil rights statute, 42 U.S.C. § 1988 (1988), which expressly allows a court to award a prevailing party a reasonable attorney's fee "in its discretion." *De Jesus*, 918 F.2d at 233-34. Even with that discretionary language, a court cannot deny a reasonable attorney's fee in the absence of special circumstances. *Id.* (citing *Hensley v. Eckerhart*, 461 U.S. 424, 429 (1983)).

401. *Carr v. Blazer Fin. Servs. Inc.*, 598 F.2d 1368 (5th Cir. 1979); *In re DiCianno*, 58 Bankr. 810 (Bankr. E.D. Pa. 1986). In *Manor Mortgage Corp. v. Giuliano*, 596 A.2d 763 (N.J. Super. Ct. App. Div. 1991), the defendant-consumer recovered legal fees and costs when the lender lost its bid to obtain a commitment fee from the consumer after the latter had rescinded the transaction.

magically convert the item into a part of the finance charge. The availability of this choice destroys the uniformity envisioned by Truth in Lending and puts the consumer in a quandary that prevents an effective comparison of terms. If an item is not actually part of the finance charge, the lender should disclose it in its proper category. The Lender's failure to do so should not result in another designation of the item, but rather in an appropriate sanction for his failure to comply with the Regulation.

Furthermore, between a lender and consumer, any insurance transaction should be separated from the financing transaction. If the consumer has to provide insurance to secure the lender's investment, he should be able to do so without having this separate requirement affect the finance charge in the credit transaction if the premium is not really part of that charge. It is questionable whether the inclusion of the insurance information on the disclosure form serves the purpose of giving the consumer an opportunity to evaluate the insurance offer. Many consumers are lulled into signing up through the lender for the required insurance coverage because they think that it is too late to make another choice or that they are simply getting a good deal through the lender. The insurance problems can be avoided by the adequate disclosure of price information and by treating the insurance transaction separately. It has been suggested that the information about price can be provided through an insurance cost index that could be applied to the kind of coverage.⁴⁰² That index and a review period for the consumer might be an effective combination to solve the insurance concerns.

Some improvement can also be made in the rescission process. The rationale given for making the right of rescission a part of Truth in Lending is as good today as it was when the statute was enacted. The consumer needs some time to think about subjecting his home to a lien. If a creditor abridges the consumer's right to reflect about the transaction by taking the consumer's signed form indicating no rescission prior to the expiration of the period, then the creditor has not met the regulatory requirement of giving proper notice. As a matter of clarification, an amendment is in order to make the point that any notice of non-rescission that the consumer signs in advance of the expiration of the three-day period will make ineffective the notice of the right to rescind that the creditor gives to the consumer. There is really no need for the creditor to insist on the consumer's signing such a form in advance. If the creditor wishes to have the consumer's assurance of no rescission, he should wait until the three-day period has expired. If the consumer needs his money immediately, he may waive the

402. See Golann, *supra* note 306, at 1321.

right of rescission in a genuine emergency. However, even then, the consumer must describe the emergency in a statement that cannot be in printed form.⁴⁰³ This waiver procedure is available, therefore, in exceptional circumstances and the pre-signed form of non-rescission was not intended as a substitute merely to hasten the disbursement of the funds.

403. Regulation Z, 12 C.F.R. § 226.23(e) (1992). The objective here is to ensure that the waiver is treated as an exception rather than as a routine transaction.